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# ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM

## SELECTED ESSAYS

PREPARED FOR THE USE OF THE

SUBCOMMITTEE ON
ECONOMIC GROWTH, TRADE, AND TAXES

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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# LETTERS OF TRANSMITTAL

OCTOBER 16, 1987.

Hon. PAUL S. SARBANES,
*Chairman, Joint Economic Committee,*
*Congress of the United States, Washington, DC.*

DEAR MR. CHAIRMAN: Transmitted herewith for the use of the Joint Economic Committee, the Congress, and the interested public is a collection of essays on "Economic Development in Latin America and the Debt Problem." The collection includes 15 studies on topics likely to be of interest to the 100th Congress.

This volume is one of a series of area studies prepared for the Joint Economic Committee by the Congressional Research Service of the Library of Congress. Earlier, CRS produced two volumes on the economic problems of Latin America: "Dealing With the Debt Problem of Latin America," published by the Joint Economic Committee in 1985; "The Political Economy of the Western Hemisphere," published by the Committee in 1981.

We wish to thank the Congressional Research Service for making available the services of Alfred Reifman, Senior Fellow in International Economics, and Albert Mayio, an economic consultant on this project. They were responsible for organizing and editing the volume as well as preparing the overview and two of the studies. The project was planned and supervised for the Committee by George Tyler.

The views expressed in the selected essays are those of the individual authors and do not necessarily represent the views of the Joint Economic Committee or of its individual members.

Sincerely,

LLOYD BENTSEN,
*Chairman, Subcommittee on*
*Economic Growth, Trade, and Taxes.*

October 2, 1987.

Hon. Lloyd Bentsen,
*Chairman, Subcommittee on Economic Growth, Trade. and Taxes, Joint Economic Committee, Congress of the United States, Washington, DC.*

Dear Mr. Chairman: In response to your request, we enclose a collection of 15 individual studies bearing on Latin America's development and debt problems.

The essays were prepared by experts in the Congressional Research Service, universities, and private business and cover a wide range of problems. They range from domestic economic policy of the Latin American governments and international financial developments, to the interaction of politics and economics in the area.

Because the severe debt problem heavily influences Latin America's economic outlook and U.S. relations with the area, we include six approaches to the problem. The analyses are in general agreement; the proposed solutions are not.

The volume was prepared under the general direction of Alfred Reifman, Senior Fellow in International Economics at the Congressional Research Service, and Albert Mayio, a CRS consultant and retired foreign service officer with extensive experience in Latin America.

Sincerely,

Joseph E. Ross,
*Director, Congressional Research Service,*
*Library of Congress.*

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Marcelo Diamand is an Argentine industrialist and economist.

Kristin Hallberg was an assistant professor at Colby College and is now on the staff of the World Bank.

Albert Mayio is an international economist and former Foreign Service Officer.

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# OVERVIEW

By Alfred Reifman and Albert Mayio

In 1986, despite substantial increases in per capita Gross Domestic Product in seven countries in the Latin American-Caribbean region (LAC) that suggest these countries might finally be emerging from their most protracted period of economic stagnation since the 1930's, the other eighteen economies showed few signs of recovery. Only three of these had positive rates of growth in 1986, and these were slight; the remaining fifteen had a median negative growth of 2.8 percent. The countries with high per capita growth rates ranging from 3.7 to 5.8 percent were Argentina, Barbados, Brazil, Chile, Colombia, Peru and Uruguay. All of these were either oil-importing countries or marginal exporters of oil.

Three main developments account for the failure of the LAC economies to recover more rapidly from the slump that began in 1980–81: (1) the prolonged sluggishness of the prices of the area's main exports; (2) the unwillingness of domestic savers and investors to repatriate their capital and of foreign lenders and investors to return to the LAC region in strength as a result of the high risks seen in putting money into an area where virtually all countries have stopped making amortization payments on their huge external debt, and a few have lagged in or actually stopped paying interest on that debt; (3) generally contractionary economic policies intended to curb investment, consumption and imports so that governments still giving the highest priority to maintaining their countries' creditworthiness have enough foreign exchange to keep paying interest on their foreign debt.

In 1986, aided by the decline in oil import prices and lower interest rates on their foreign debt, the seven countries that achieved large increases in per capita national output followed more expansionary policies. But this was at a cost of a 27 percent decline in their trade surplus which translates into a reduced capability to meet interest payments. To appreciate the LAC's trade difficulties, in 1985 the average prices of Latin America's ten leading exports were 26 percent below their 1980 levels. The outlook for stronger commodity prices is unclear. Moreover, there is little likelihood that foreign lending and investing in Latin America will increase substantially any time soon.

These problems pose a difficult dilemma for Latin American governments. If they could fine-tune their economies they might be able to keep up the interest payments on their foreign debt and at the same time manage enough economic expansion and increase in living levels to retain popular support for their conservative economic policies, a cornerstone of which is maintaining international creditworthiness. That is, at the cost, say, of two or three percentage points in the growth rate which keeping up with interest payments might entail, they still might be able to achieve a good annual growth rate in per capita GDP of two to three percent or more. The history of economic policy in Latin America does not, however, give much ground for optimism that once expansionary forces set in, they can be controlled to suit the objectives of the government. Moreover, the assumption that developing countries can undergo the industrialization process and still generate trade surpluses flies in the face of the history of economic development. Except for unusual cases like the petroleum exporting countries in the 1970's, one of the essential charactristics of developing nations undergoing industrialization is their need to import capital goods, technology and equipment that is beyond their current export capacity to pay for. They have no alternatives but to borrow abroad, obtain foreign investment or cut consumption. Since non-Communist countries that are ruled by elected governments tend not to cut consumption very much, they must rely to a great extent on borrowing abroad and bringing in foreign investment, if they want to industrialize rapidly.

The political problem thus posed for Latin American governments is that they must convince their people, many of whom have suffered severe declines in living levels over the past five or six years, that maintaining their countries' creditworthiness should continue to have high economic priority even though this means the sacrifice of some economic growth in the short and medium term. Maintaining the countries' credit standing should gradually act to restore the confidence of foreign lenders and of domestic and foreign investors, thereby ensuring greater growth over the long run.

The trouble is that improving creditworthiness requires not only keeping up with interest payments on the foreign debt but also undertaking reforms to liberalize the economies. Liberalization, however, in traditionally statist South America may now be more difficult politically than ever before because of the identification of liberalization with repression under the many military regimes of the 1970's and early 1980's.

Substantial improvement in world commodity prices and the boost this would give the Latin American economy would make the task of reform much easier. Failing this, it does not seem probable that the Latin American countries can continue both to grow and to keep current on their interest payments abroad. Consequently, foreign creditors will have to consider whether the ad hoc arrangements by which the debt problem has been managed so far are viable for much longer. Latin American governments are already under pressure from nationalist/populist quarters to take an aggressive stance with foreign creditors. That pressure will mount if the current recovery appears to be in danger of being choked off.

The essays that follow discuss the debt problem from various perspectives: the context of foreign trade and investment, Latin American domestic policies and politics, and the problem presented by political change in Latin America to United States foreign policy.

## ECONOMIC TRENDS IN LATIN AMERICA

In the opening essay, Karen Morr reviews Latin America's economic history and particularly the development record since the end of World War II. In her scrutiny, she examines not only the growth record but the progress made in meeting basic needs and improving the physical quality of life. She finds the region's performance to be one of erratic but considerable progress until the 1980's when unfavorable external developments and adjustment policies to cope with them brought about a combination of prolonged economic stagnation and accelerating inflation.

Morr provides an introduction to a number of issues that are pertinent to the current situation in Latin America, some of which are elaborated upon in other essays in this volume. She begins with the patrimonial tradition which a number of experts on Latin America believe explains the dominance of the state in economic life, the pervasiveness of elite rule, the tendency of the middle sectors to side with the upper classes against the urban and rural poor, and the attitudes of resignation and acceptance of their wretched living conditions by most of the rural poor.

The second issue she treats is income distribution. Her examination of several studies of the subject leads her to find that the evidence is too fragmentary to conclude that income has become increasingly concentrated over the 1945–80 period. While some studies indicate that income distribution may have become more highly skewed since 1960, this may not be true for the period as a whole. The reasoning is that industrialization and urbanization have raised average incomes as large numbers of impoverished and underemployed rural people have moved into the cities and found employment either in traditional jobs or in the informal urban sectors.

A third issue discussed by Morr relates to the continuing debate on appropriate adjustment measures to correct monetary and balance-of-payments disequilibria. The division between "structuralists" and "liberal" or "free market" advocates that arose in the 1950's over the import substitution way to industrialization lives on, she writes and, in fact, may have become even sharper than before as a result of the endeavor of some of the South American military regimes to apply the "liberal" formula for stabilization and growth. The inference that can be drawn from Morr's treatment of the military's application of these policies is that these were not really a true test of free market principles in that the exchange rate was kept deliberately over-valued for long periods, and the central government continued to play a dominating role in economic life.

The fourth issue that Morr introduces is the debt burden and its impact on growth prospects. Basing her estimates on studies done in late 1984 before the steep decline in oil prices, she presents projections indicating that while Brazil and Mexico would be resuming their 1970–80 growth rates by 1985 or 1986, many Latin American countries would not be recovering their 1970 rates until 1990 or so. Writing as of early 1985, Morr does not commit herself to either the pessimistic or the optimistic growth projections available at the time. She points out, however, some of the difficulties in the way of more rapid growth: the pressures on the new democratic governments to meet social and economic demands that were ignored by the military regimes, the spending propensity of populist governments, the possibility of cyclical down-turns in industrial country markets for Latin America's exports, and finally, the more complex nature of the economic decision-making process in democratic politics. Since Morr's article was written, Latin American governments have followed generally conservative policies. Though some of them are in arrears on foreign debt servicing, on the whole they have kept up with their interest obligations as these have been adjusted by agreement with their creditors, even though recovery from the recession that began for them in the late 1970's or early 1980's has been slow. Her warning that some governments may give way to demands for more radical positions on interest payments is still valid.

## THE DEBT PROBLEM

Economic growth in 1986 may bolster the position of the experts who have held all along that the debt problem is manageable without extraordinary measures of debt relief; other experts still disagree.

Because the debt problem of Latin America hangs over the area like a dark cloud, we include six essays on the subject. Alfred Reifman gives a brief history of the origins of the problem, and critiques the major options for dealing with it. Christine Bogdanowicz-Bindert gives an early reaction to the Baker Plan of 1985. Jeffrey Sachs presents a full analysis of the debt "crisis" and advances a specific proposal to grant relief to those debtors meeting his criteria. The World Bank experts discuss steps being taken to "implement the consensus" on dealing with the debt problem. Victor Urquidi proposes that interest payments be made partially in local currencies, the way the Marshall Plan dealt with the debt problem in postwar Western Europe. Patricia Wertman describes and analyzes a wide range of proposed solutions to the problem. Finally, William Cline views the current situation optimistically, proposes a variety of measures to increase bank lending, and rejects proposals to forgive some of the debt.

*Dealing with the debt problem.*—In the introductory essay in this section, Reifman notes that the debt problem arose from adverse world economic conditions in the 1980's, inadequate measures to deal with these conditions by the debtor countries and imprudent lending by many commercial banks. On policy, he argues that the case-by-case approach of the U.S. Government has been successful in preserving the solvency of the U.S. banking system but has failed to restore the creditworthiness of the debtor countries and has left them with per capita incomes well below those of 5 to 10 years earlier.

The Baker Plan, designed to allow for economic growth as well as deal with the debt problem has had only a limited success, in Reifman's view. The Mexican agreement has given that country breathing space to press forward with measures to restore economic growth. However, Mexico is absorbing over 40 percent of the private and public funds the Baker Plan envisages for all debtor countries. The financial flows proposed by Baker, writes Reifman, may well be inadequate to resolve the Latin American debt problem in an environment of economic expansion there.

As a result, a variety of alternative plans are being advanced. Most of these involve some degree of debt forgiveness by the commercial banks. The advantage of forgiveness is obvious—a heavy burden would be lifted from the shoulders of the debtor countries. However, there are numerous disadvantages. Most important, Reifman observes, debt forgiveness might threaten the solvency of some large U.S. banks and yet provide only limited benefit to the debtor countries since they are not now making repayments of principal of their indebtedness.

*The United States reconsiders.*—Christine Bogdanowicz-Bindert analyzes Latin America's debt problem much the same way as Reifman. However, she concludes that the problem is more serious than many anticipated, and makes a variety of suggestions on how to deal with it. Finally, she welcomes the healthy pragmatism in the proposals of Secretary of the Treasury Baker at the October 1985 meetings of the World Bank and the International Monetary Fund, but fears they do not go far enough.

The debt "crisis" of 1982, when Mexico announced it could not meet its payments on foreign loans, was met by concerted action of the U.S. government, the IMF, the commercial banks, and the debtor governments. The "crisis" was replaced in 1984–85 by the debt "problem" as improved balance-of-payments results led many observers to conclude that the crisis was over and what was left was a manageable problem that was on the road to resolution.

However, despite lower interest rates and a declining dollar, by the end of 1985 the problems began to be recognized as more persistent and serious. Slow economic expansion in the United States and the other industrial countries, continued declines in prices of the basic export commodities, interest payments (while reduced) still absorbing some 30 percent of export earnings, and no increase in private or official capital flows to Latin America combined to worsen the balance of payments of the area. This developed despite continued restraints keeping the volume of Latin American imports an unsustainable 40 percent below 1982 levels.

The result of all this is depressed standards of living which are not expected to reach 1980 levels until the next decade. Such prolonged stagnation, Bindert writes, would be a threat to the governments of Latin America, especially the new democracies. "With double-digit unemployment, more than half the working population holding part-time jobs, and no social security safety net, the governments of debtor nations were clearly sitting on a social powder keg," Bindert writes.

She hails the Baker initiative of October 1985 for officially recognizing "that the debt crisis is here to stay, and that austerity has to give way to growth." At the same time she expresses concern that unless the United States supports both an increase in the World Bank's capital and a change in its lending practices, the Baker recommendations will be inadequate.

Another deficiency in the Baker strategy, according to Bindert, is that it deals almost exclusively with the big debtors. There are good reasons for this. One, if the strategy is successful, these countries might eventually restore their creditworthiness and resume normal borrowing. Two, if they were to default on their loans, the U.S. and world banking systems would be threatened.

But, Bindert asks, "What is the strategy going to be for smaller and poorer countries which should never have borrowed so much on commercial terms in the first place? Unless explicitly guaranteed by the World Bank or the U.S. government, credits to these countries will remain scarce. . . . There must be a mechanism to clean the slate."

She suggests debt service payments limited to a percentage of exports, perhaps 20 to 25 percent, in contrast to the 40–45 percent which most small debtors now bear. The difference between the payments arrived at by such a formula and the interest actually due would be capitalized.

But, concludes Bindert, for many debtors "debt is growing faster than their net export proceeds; they will simply never catch up. . . . For these countries, the banks and industrial countries should consider writing off part of the debt." Since the debtors eligible for such treatment would be the smaller debtors, there would be no risk to the banking system which, in her view, could not be met by liberal bank regulators.

*Sachs on debt relief.*—Jeffrey Sachs agrees with Bindert and develops her suggestions into a detailed program. He argues strongly for strict conditions that he lays down.

First, he reviews the history of the debt crisis that began in August, 1982 with Mexico's announcement that it could no longer service its external debt. Since then, the strategy of the creditor banks and governments and international lending institutions has been dominated by the goal of maintaining the servicing of commercial bank claims by the debtor governments. By rescheduling loan maturities and some refinancing, this strategy has enabled most of the debtor countries to keep current with their interest payments.

While this has benefited the commercial banks, Sachs writes, the impact on most of the debtor countries has been "disastrous". In some of these countries, the heavy drain of interest payments and the austerity measures employed to reduce import levels have contributed greatly to depressed economic activity and to severe social and political strains.

The strategy of the creditor groups might have worked, Sachs implies, if world markets had responded as had been expected. But after several years of austerity measures, despite continued growth in the industrial countries, the drop in world interest rates, and the fall in the U.S. dollar, in 1985 the debtor countries suffered a substantial decline in their export earnings. This, together with a further drop in foreign bank lending, led many observers to believe that the current strategy was not likely to solve the debt crisis.

Treasury Secretary Baker's proposal of October 1985, according to Sachs, was an acknowlegement that the debtor countries "were not rebounding from the crisis of the early 1980's as had been forecast." Moreover, in Sachs's view, the Baker "plan" did not change the current strategy, since it still put the emphasis on the debtor countries meeting their interest obligations on a timely basis and piling up more debt and interest payments to do so.

In contrast, Sachs sees Senator Bradley's proposals as breaking "new political ground" by presenting a debt strategy based on partial debt relief rather than debt rescheduling and full interest servicing. Sachs does not, however, give an analysis of the Bradley plan. Instead, he presents his own recommendations: (1) Establish objective criteria for granting different degrees of relief—for example, countries that suffered a decline in per capita GDP of 25 percent or more since 1980 might have their interest payments deferred for 10 years, those that experienced a decline of 15 to 25 percent might have their payments postponed for five years; (2) give new lenders priority over existing creditors as to repayment of interest and principal.

Conditioning debt relief on losses in income, Sachs acknowledges, is risky since it will be difficult to determine how much of the loss may be due to circumstances beyond the control of the country and how much to bad policies. However, loss of income would not be the only factor taken into consideration. A country's eligibility for debt relief would also depend on living levels, the magnitude of the external and internal shocks that may have caused the loss, and the extent of hidden income reflected in capital flight.

About half of the Latin American debtor countries, including the largest, Brazil and Mexico, would not be eligible for debt relief, according to Sachs's calculations. Nevertheless, these countries need help also since their growth is endangered by low levels of investment which are, in part, the result of the large decline in foreign lending. However, existing creditors can hardly be expected to increase their present levels of lending, since they are still not receiving amortization payments on existing loans, and the ability and willingness of many Latin American countries to continue meeting their interest rate obligations is uncertain.

In Sachs's view, new lenders are needed. But to attract them, it will be necessary to give them precedence over existing lenders. The latter should be persuaded to accept junior status as to claims on the debtor countries because the money the new lenders provide should stimulate investment and growth and thereby increase the debtors' ability to meet their debt servicing obligations.

Sachs would also tie new loan packages to performance by the debtor countries as the current strategy and the Baker and Bradley recommendations do. But he believes that the standards of performance stipulated by these other approaches are unrealistic. Rapid liberalization—opening up of foreign trade, privatization of state enterprises and a favorable climate for private foreign investment—has rarely worked, Sachs argues. These changes take time. Moreover, they require favorable economic conditions to begin with, something that was lacking in the liberalization programs that were undertaken in Latin America in the last two decades. Sachs refers to the study by Anne Krueger of 23 liberalization attempts in the 1950's–70's.[1] Only four of these attempts had succeeded as of 1978, according to Sachs, and only after a gradual process that began in highly favorable macro-economic conditions.

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[1] Krueger, Anne O. "Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences." A Special Conference Series on Foreign Trade Regimes and Economic Development, Vol. 10, National Bureau of Economic Research, New York, 1987.

Sachs' final point is that creditors should also insist that the debtor countries ensure fairness in their liberalization and stabilization programs. "Many of the basic problems of Latin America are ones of fairness in the first place," Sachs writes. In the last ten years, unfairness has increased as the wealthy have been able to shift the burdens of adjustment to the poor by capital flight and low taxes. "The creditor governments, and especially the United States, should insist that the debtor governments come up with fair and equitable burden sharing as part of the adjustment efforts," he writes.

John Williamson, commenting on Sachs' paper, raises a number of questions that show how difficult it is to come up with a satisfactory debt relief approach to solving the debt problem. Generally, however, Williamson implies that most of these problems are surmountable. He demurs from Sachs principally on two points: (1) He believes Sachs exaggerates the scope of the debt crisis—several countries have regained access to international credit by their management of the debt problem; (2) Sachs' criterion of income loss is inadequate. Williamson believes an international tribunal should assess the claims of the debtor countries for debt relief, taking into consideration a number of factors, notably: (1) A decline in per capita income; and (2) a presumption that economic recovery is being impeded by the debt overhang.

William Cline, commenting on Sachs' work, also argued that the debt problem was not as critical as he describes it. Falling interest rates and the probability that commodity prices in current dollars would rise as a consequence of the fall of the real value of the dollar would help several of the debtor countries. Cline also expressed the fear that debt relief would impair indefinitely the access of the debtor countries to international credit and capital markets. Moreover, in Cline's assessment, both the Bradley and the Sachs plans demanded too much of the commercial banks.

Peter Kenen's objections to the Sachs plan was that it was too short-term. Debt relief, he said, should be spread over a longer period, say, ten years, in order to ensure that the debtor countries carried out their reform commitments. He also doubted that subordinating old loans to new ones would result in a significantly increased inflow of new money.

Benjamin Friedman argued for a write-down of LDC debt by the commercial banks. Though the banks would have to raise new capital at "unattractive prices", this would be preferable, he argued, to the present situation where the reduced value of bank portfolios is being ignored, thereby risking grave problems in the future.

*The World Bank on debt.*—The World Bank, in "Developing Country Debt: Implementing the Consensus," questions how well the consensus on dealing with the international debt problem is being implemented. The Bank notes with concern the steady decline in new lending from all sources since 1981. Most problem debtors, the report points out, have "avoided a breakdown in their relations with creditors by adjusting to the high real cost of interest, . . . the rapid contraction of new capital inflows [and the fall of non-oil commodity prices to their lowest level in at least 50 years] through a combination of rescheduling and sharply reduced imports. For many, however, this has been done at the cost of stalled development and falling per capita incomes."

The World Bank report endorses Secretary Baker's 1985 speech that economic growth in the debtor countries is necessary if they are to work their way out of the debt problem and that they "must be assured of adequate financial resources to support their adjustment efforts." Yet, "the weakness of new commercial lending was matched by a disappointing lack of developments in rescheduling arrangements." The disappointing volume of multi-year rescheduling applies to both private and public lenders.

Finally, what new lending there was by commercial banks has been heavily concentrated. Mexico received a major commitment, $6 billion, but very little new lending was promised to other debtor nations. While Mexico's need was urgent, the World Bank report notes, the need of other countries is equally pressing.

The report argues that "bankers' attitudes have hardened with the passage of time * * * the market, left to itself, will not provide the level of financing needed to sustain the debtor countries in their commitment to growth-oriented adjustment."

The report asserts that new initiatives are needed. Most important, official creditors must lead or no one will follow. This means more lending by governments and international financial institutions as desirable in itself and as a means to engage private creditors again. Partial guarantees of private loans by official agencies is an option. Contingency financing, such as that provided in the Mexican agreement, is another.

Increased flow of equity capital, in part by the conversion of some of the debt to equity investment, is also desirable in the eyes of the World Bank. Terms of borrowing could be eased and rescheduling for multi-year needs to be vigorously pursued.

The Bank advances these ideas as suggestions of the wide range of options that need to be implemented. Debt forgiveness, as proposed by Senator Bill Bradley and, elsewhere in this volume, by Professor Sachs, is not considered.

The report concludes grimly, that time may be running out, that "if a long-term solution to debt problems is not pursued vigorously while global conditions are broadly supportive, it may prove beyond reach as they become more difficult."

*Part-payment in local currency of interest on external debt.*—In his essay, Mexican economist Victor L. Urquidi presents an innovative approach to ease the debt-servicing problem of the Latin American economies.

The approach calls for the debtor countries to work out with creditors and multilateral financial agencies an arrangement under which a part of the interest due on their debt would be paid to the creditors in local currency. The proposal is similar to the repayments in local currency of some Marshall Plan and P.L. 480 loans.

The creditor financial institutions could then lend the local currency, under conditions agreed upon with the host government, for projects that would enhance the export-earning or import-saving potential of the country or otherwise contribute to its increased productivity. Interest on the funds would be payable in part in dollars or other hard currencies.

A few arrangements of this kind, albeit on a very limited scale, are in operation in several developing countries. The essential principle of the approach was the subject of a critique by a team of economists at the Institute for International Economics in early 1985.[2] A basic objection is that the commerical banks would probably not find the proposal attractive if implemented on a large scale. It is worth noting, however, that the choices on how to handle the Latin American debt are all choices among lesser evils.

*Options for solution.*—Patricia Wertman describes and analyzes 13 different proposals to deal with the debt problem. These proposals range from current policy, the Baker Plan, to outright repudiation of the debt, the Castro Plan. Wertman also presents a set of criteria for evaluating proposals to deal with the problem.

*New approaches to bank lending.*—In the final paper on debt, William Cline presents a variety of plans to enhance lending to Latin America by commercial banks. He argues that proposals by Bradley, Sachs and others to forgive some of the debt is unnecessary because the debt situation is easing as interest rates have fallen and commodity prices rise; and because forgiveness would be counterproductive as it would reduce the creditworthiness of the country, inhibiting the return to voluntary lending. Moreover, most plans—Bradley's, for example—would provide only modest economic advantages for Latin America. Finally, Cline concludes, as do others, increased lending from official sources (the World Bank and Ex-Import) is essential.

Cline believes new approaches are needed to encourage the banks to expand their commitments to the debtor countries. Such a strategy would be based on two principles. First, new credits should be accorded preferred status over previous debt, to provide greater security to banks that continue to participate in the new-money process. Second, different forms of participation should be available to the three different categories of banks:

—those banks that believe a debtor country can resolve its problems, and hence regain market access over the medium term. They would purchase bonds or continue to extend new loans, preferably with senior status.

—those banks that view a country's problems as so desperate that a substantial portion of existing claims will inevitably be lost. They would be permitted to withdraw from the lending process, by discounting their prior loans, with the benefit conveyed to the debtor country.

—those banks that simply seek to avoid contributing new money while expecting to maintain their prior claims via the actions of other lenders. Cline's strategy would seek to eliminate these "free riders."

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[2] Bergsten, C. Fred, Cline, William R. and Williamson, John "Bank Lending to Developing Countries: The Policy Alternatives." Institute for International Economics. Washington, D.C., Apr. 1985, pp. 175–79.

## FOREIGN TRADE AND INVESTMENT

### *Debt and development in Latin America: The role of foreign direct investment*

The severity of the debt problem in Latin America would be considerably lessened if other types of financing could be expanded to cover the gap created by sharply reduced commercial bank lending since the early 1980's. In her essay, Kristin Hallberg examines recent studies to assess the potential of direct foreign private investment to help Latin America out of the debt trap. According to Hallberg, it was the abrupt decline in this lending—a traditional way of enabling borrowers to refinance maturing debt without too much strain—that brought most Latin American governments near the point of default.

She concludes that the possibilities in this direction are not very large. In her opinion, the best estimates suggest that foreign direct investment is not likely to supply as much as 20 percent of the region's financial requirements from abroad.

More important, however, than foreign investment's role in providing foreign exchange are its indirect effects, Hallberg believes. Such investment serves as a catalyst for attracting additional commercial bank lending as well as generating a multiplier effect on output and exports if it is channeled into sectors with a high growth potential.

Commerical bank lending will continue to be the most important source of foreign exchange next to earnings from exports of goods and services. Though the three studies Hallberg examines project a sharply reduced flow of commercial bank lending from the 1981 level, private foreign banks are still expected to produce 50 to 60 percent of the total external financing needed to cover expected current account deficits. These are projected at an average of $25–26 billion per year in 1985–87 in one of the studies. Another study projects current account deficits of the order of about $14 billion annually for the same period, assuming a high growth rate in the industrial countries.

Although Hallberg does not see direct foreign investment replacing a substantial part of the external financing now provided by foreign banks, her analysis of the pros and cons of foreign private investment makes a strong case for its usefulness in the Latin American development process. Whether Latin American policy makers are of the same mind is another question. However, those who want foreign investment must realize, Hallberg warns, that policy stability is of the utmost importance in attracting and keeping foreign firms.

Multinational companies will continue to invest even if host country policies are relatively strict, Hallberg writes. What foreign companies require, however, are stable and rational macroeconomic policies as well as consistency in the rules and interpretations affecting direct investment.

### *Regional economic integration in Latin America*

Latin American policy makers tend to be pessimistic about greatly expanding their exports because of growing protectionist trends in the industrial countries. It would seem logical, therefore, for

Latin American governments to look again to regional integration schemes as a means of increasing trade and diversifying markets. So far this has not happened. Bleger explains why.

He explores the difficulties that the Latin American Free Trade Area (LAFTA), its successor, the Latin American Integration Association (LAIA), and the Andean group encountered, why the integration movement in Latin America waned in the 1970's, the obstacles standing in the way of its revival, and the possibilities it offers for quickening the development process in the LAC area.

A central reason for the failure of LAFTA to reduce trade barriers and to increase regional trade seems to have been the lack of commitment by the contracting parties and their unwillingness to surrender, even partially, their sovereignty in issues related to domestic economic policies. At the same time, in defense of the architects of LAFTA, it must be said that the enterprise was a revolutionary step for Latin America whose trade historically was, and is, primarily with Western Europe and North America, and more recently, with Japan. Of all the reasons that Blejer gives for LAFTA's failure, perhaps the most important was the great disparities that existed in economic development among the relatively industrialized countries, Argentina, Brazil and Mexico on the one hand, and the intermediate countries such as Colombia, Chile and Venezuela on the other, and the differences between both these groups and the relatively unindustrialized countries such as Bolivia and Ecuador.

The Andean Group integration scheme, established in 1969, offered the lesser developed countries a better chance of achieving a true common market. Unlike LAFTA, the Andean Group was committed to developing a common external tariff, cooperative industrial planning, a common investment code, and harmonization of exchange rates, fiscal and commercial policies. Perhaps an even more important difference was the Andean group's undertaking to compensate member countries that received the least benefits or suffered "injury" under the programs.

Fulfilling these various commitments proved extraordinarily difficult. But enough progress was made, Blejer implies, to suggest that the Andean Group is a viable enterprise. Valuable momentum, however, has been lost. In the 1970's, the two oil shocks weakened the commitment to integration as the oil-producing members made windfall gains, and the oil-importing members suffered huge payments deficits. The withdrawal of Chile in 1976 because of the Pinochet government's decision to pursue an independent trade and investment policy was another blow. Finally, the world recession of the early 1980's virtually stopped progress toward Andean integration.

Blejer observes that an important development that undermined the integration movement in the Andean and Southern Cone areas was the adoption by the military regimes there of policies intended to force their economies into a free-market mould. These policies included drastic trade liberalization measures that were not consistent with other internal policies. Underlying the military regimes' policies was a development strategy clearly opposed to the one implied in the Latin American integration schemes. Moreover, the surrender of sovereignty to regional multilateral agencies over economic decisions was anathema to the military regimes.

Though Blejer does not say so, the emphasis on equity—the fear that one country's gain implies another country's loss—has also inhibited moves toward economic integration in Latin America.

Aside from the apparent current lack of political and business community interest in pushing regional integration, the fact is that the civilian governments have their hands full in coping with the economic crisis that besets them all. Regional integration, even where it is seen as a possible vehicle for reducing Latin America's dependence on the industrial countries, has a very low priority in comparison with other pressing problems.

## DOMESTIC POLICY

### *The debate on stablization policy*

If the debt problem is the most immediate concern of the Latin American countries, the control of inflation ranks close to it in importance. Since the late 1940's, ideological warfare has been waged between Latin American statist-oriented structuralists and free-market monetarists over the best strategy to achieve sustained economic growth. Where the structuralists have subordinated the control of inflation to expansionary policies to promote growth, the monetarists have insisted that sound growth is impossible in an inflationary environment.

Edmund Sheehey explores the issues in the debate. He writes that contemporary Latin American monetarist doctrine goes beyond stabilization and seeks integration of the domestic economy with the world economy and a radical restructuring of the national economy along free-market lines. What is new in the structuralist critique is that it now claims that the monetary contraction deemed essential by monetarist doctrine for curing inflation is in itself inflationary.

The argument is, first, that monetary contraction increases the cost of working capital to business firms; and, second, business skepticism about the success of stabilization efforts—product of so many failed programs—causes firms to raise their prices at a pace far above the rate that would be projected on the basis of indicators such as money growth and wage increases.

Devaluation is an important element of orthodox stabilization programs. Their proponents see devaluation as raising the relative prices of internationally traded goods, thereby stimulating their production and exportation. The structuralists, on the other hand, see the main impact of devaluation in developing countries as reducing imports. Since these are indispensable as inputs for domestically produced goods, output falls off.

Since exports are primarily products of agriculture or of mining, the output of which cannot be increased very much in the short run anyway, the balance-of-payments improvement that may come about through monetarist policies is primarily the result of the drop in imports and the related slow-down of the economy. This recession in itself has price-raising effects as firms try to offset lower sales by raising prices.

Sheehey notes also the structuralist view that, through devaluation, monetarist stabilization programs have the effect of transferring income away from low-propensity savers such as workers to high-propensity savers such as exporters and producers of import substitutes, thus lowering general effective demand and reinforcing recessionary tendencies.

Sheehey finds inconclusive the empirical evidence offered by both sides. He notes, however, that even a structuralist type of stabilization program must include some components of the orthodox approach. He sees, though, two main substantive differences between the two schools: (1) The structuralist approach would be more gradual in order to avoid serious recession; and (2) it would be more interventionist, stressing among other measures a policy sequence that would boost exports, and thereby increase the utilization of excess capacity and increase employment and then, from a strong employment base, proceed to liberalize imports.

Sheehey sees similarities between the two schools in their aims and even in their instruments. Their differences hinge on the emphasis they put on use of these instruments: the orthodox side stresses quickly improving the balance of payments and checking inflation; the structuralists want to do the same thing but insist on avoiding serious declines in output and employment. Lamentably, Sheehey comments, both sides "can observe the same events and analyze the same data, yet adopt strongly contrasting views."

### *The perversity of economic incentives in Latin America*

In addition to the ideological split between structuralists and monetarists, another obstacle to coherent economic policies has been the tradition of softening the disparities in income distribution by all kinds of interference with the market in regard to prices. These interferences are the topic of the essay by Sidney Weintraub.

These actions are ostensibly meant to protect the poorest groups in the population. In fact, however, the middle classes also benefit. While populist governments have been the worst offenders in this regard, conservative governments have generally been reluctant to do away with all subsidies and price controls. The "new-style" military regimes in Argentina, Brazil, Chile, and Uruguay that installed themselves in power in the 1960's and 1970's made much of removing impediments to the free interplay of market forces in determining prices. While they made some progress in some sectors, with the exception of Brazil, they also carried out an exchange rate policy that increased price distortions.

This was the policy of lagging devaluations of the exchange rate behind the rate of inflation so that the national currency remained overvalued with respect to foreign currencies. In this way, imports were encouraged because they became relatively cheap as compared with domestic products.

"Getting prices right" or seeing that prices of goods and services accurately reflect market forces is an integral element of orthodox stabilization programs such as those of the IMF. Weintraub explains why this should be a main goal of economic policy everywhere, but particularly in the developing countries which can ill-afford to waste resources.

Price structures are distorted by all kinds of subsidies, incentive schemes, politically-set prices (such as public utility rates set below the cost of production) and exchange rate policies. One of the most glaring and counterproductive examples of such price distortion cited by Weintraub is the almost universal practice in Latin America of fixing farm prices below the level the market would set to bring supply and demand into balance. This is done to keep down the cost of living of the urban population not only to curry favor with them but also to reduce workers' pressure for increased wages based on cost-of-living increases.

Since Latin American governments do not generally compensate their farmers for the slim profit margins or even losses suffered as a result of government price-fixing, farmers have little or no incentive to increase production. Agriculture stagnates, and imports are needed in increasing volume to meet the basic food needs of expanding populations. The end result, generally, is to make both the budget deficit and the balance-of-payments problem worse.

Weintraub summarizes some of the main historical developments that encouraged the practice of price-fixing. These are: (1) The influence on Latin American economic policies exerted by the Economic Commission for Latin America, particularly its rationale for the import substitution industrialization policies of the 1940's and 1950's; (2) the rise of populist governments and political parties; and (3) the influence of dependency theory which attributes the cause of Latin America's economic plight primarily to what it considers excessive dependence on foreign markets and on foreign investment and borrowing. The theory tends to minimize the effect of bad internal policies as a possible cause of Latin America's economic troubles.

The recession of 1981, the sharp decline in new inflows of loans and investment from abroad and the recourse to the IMF which became necessary when the Latin American countries found themselves in deep trouble have forced Latin American governments to undertake the altering of relative prices. This, according to Weintraub, they are attempting to do by removing subsidies, requiring state enterprises to charge prices that will cover costs, adopting realistic exchange rates and removing controls that keep interest rates artificially low.

The social costs have been high, and the political repercussions have not yet been fully felt. Structural adjustments required for long-term growth involve not only "getting prices right" but shifting resources from the public to the private sector. In Weintraub's words, "The staying power of countries for these longer-term structural adjustments is a major current unknown." This, in Weintraub's view may not be so much a question of popular resistance to these measures as of convincing the political leaders that these adjustments are necessary. The process of correcting relative prices is generally forced upon them by necessity. If the necessity subsides as it may if the world economy continues to improve, the will to go through with the structural adjustments may falter.

An equally important point that Weintraub makes is that Latin American policy makers can not absolve themselves from responsibility for bad economic policies by blaming everything on external factors. Countries have to adjust to adverse economic conditions whether the cause is external or internal. Export-led growth will continue to increase the dependence of Latin American countries on their main markets, the industrial countries. Whether they like it or not, their economic growth will thus continue to depend on the growth of the industrial economies. While they can reduce this dependence to some extent by promoting more intra-regional trade, the possibilities in this direction are limited, Weintraub believes.

### *Overcoming Argentina's stop-and-go economic cycles*

The thrust of Weintraub's essay is that sustained growth of the Latin American economies depends to a very large extent on enlarging the role of market forces and decreasing the role of the state sector. The main point of Marcelo Diamand's article is that economic policy must be based on political feasibility and an appreciation of institutional realities.

Writing of the period 1943–83, Diamand notes the Argentine economy grew so slowly because economic policy swung back and forth between the extremes of orthodox stabilization and free market policies on the one hand, and populist, statist policies on the other. Neither is valid for countries like Argentina that are highly competitive in world markets for primary products but have high-cost manufacturing sectors that under current policies cannot compete with the industrial countries in the world market for manufactures.

In Diamand's view, conventional economic thinking holds that a manufacturing sector than can not cover its foreign exchange needs either by its own exports or those of the other sectors of the economy does not deserve to survive. His reply is that the inability of Argentine industry to compete well in world markets is largely a matter of an exchange rate policy that is geared to the agricultural sector rather than to the industrial sector. As a result, Argentine manufacturers can not sell enough abroad to achieve economies of scale.

Except for England, the first country to industrialize, it is a problem all the now developed nations faced when they set out to industrialize. Diamand argues that these countries, including the United States, dealt with it by high tariffs and non-tariff barriers which were only gradually dismantled but to this day never completely eliminated.

Diamand rejects the argument that Argentina—and Latin America for that matter—have exhausted import substitution possibilities. The trouble with import substitution is not the principle, Diamand maintains, but the lack of coherent and rational complementary policies.

Argentina governments, he asserts, have never given the promotion of traditional and non-traditional exports the importance it deserves. An export-oriented strategy requires appropriately supportive policies in all areas of the economy. Diamand outlines such a strategy. While some of his recommendations are highly controversial, they bear comparison with what the Brazilian military regime did in the 1967–85 period. There were, of course, negative aspects to the extraordinarily high rate of growth of the Brazilian economy in 1967–85. But something like the pragmatic coherence of Brazilian policy during those years is what Diamand sees as imperative if

Argentina is to overcome the policy pendulum he holds responsible for his country's economic stagnation. The costs of Brazil's growth have been high, Diamand writes at one point, but Brazil has a lot to show for them. Argentina on the other hand, he observes, has incurred even higher costs with nothing to show for them.

## POLITICAL FACTORS

### *Politics and economic development in South America: The new style military regimes: 1964–85*

Although Diamand believes his critique of Argentina's erratic economic policies is applicable to other Latin American countries with world-competitive primary sectors and non-competitive manufacturing sectors, his treatment focused particularly on Argentine experience since World War II. The economic policies and performance of Argentina and four other South American countries under the so-called "new style" military or "bureaucratic authoritarian" regimes of the 1960's–80's are the subject of Albert Mayio's article.

Unlike previous military dictatorships in South America, the "new style" military regimes undertook nothing less than a revolutionary change in the institutional structure of their countries. The revolutions were meant to transform pluralist regimes into disciplined corporatist or limited democracies in which decisive power would constitutionally rest with the armed forces. In the economic sphere, all the regimes promised sustained, non-inflationary growth. To achieve it, the Argentine, Chilean, and Uruguayan regimes opted for a free market approach; the Peruvian regime chose the statist, import substitution approach; and the Brazilians, while adhering to a strategy of public sector dynamism and selective import substitution, stressed export-led growth.

The regimes scores some successes, but only the Brazilian regime achieved high, sustained growth. This success, however, was marred by hyper-inflation and the neglect of social needs. External shocks played a large role in ending the various "economic miracles" but these "miracles" were souring even before the external shocks hit in the early 1980's.

Whatever achievements the regimes could take credit for, the costs were high, particularly in Argentina, Chile, and Uruguay. Over and beyond the hardships imposed on large sectors of the population by economic policies that ultimately failed, widespread suffering was caused by the unprecedented harshness of these three regimes, and by the less systematic but occasional excesses of the Peruvian and Brazilian regimes.

The shock of this experience could strengthen the turn to democracy in the four countries no longer under military rule. Mayio believes, and in Chile also when the military restore civilian government. The ineffectiveness, except in Brazil, of the authoritarian solution to the problems of development, and its inherent repressiveness may convince political leaders and the military themselves of the need to forge a lasting consensus in favor of democratic government.

A consensus of sorts has supported the new democratic governments and their conservative economic policies up to now. As of 1985, these policies had, however, contributed to prolonging the economic stagnation that began in 1980–81, from which only Brazil had recovered. In 1986, all five countries increased their real per capita GDP appreciably. Growth, however, brings problems of its own, not the least of which are the reduction in trade surpluses and the resultant increased difficulty of keeping up with debt servicing and added demands on the treasury to improve the living levels of the poorer strata of the population.

The democratic process, which has never worked very well before in South America, will have a difficult time ahead. It has going for it, though, the revulsion of civilian political leaders against military solutions, and the main lesson of the Brazilian growth experience, namely that a Latin American country can compete effectively in the world markets for manufactured goods, if it sets its mind to it.

### *Political change in Latin America: A foreign policy dilemma for the United States*

The focus shifts in Viron Vaky's article from the tasks ahead for Latin American political leaders to the dilemmas faced by United States policymakers in dealing with political change in Latin America.

In Vaky's view, in foreign policy matters, particularly those concerning Latin America, American decisionmakers all too frequently have to grapple with the conflict between the country's humanitarian and democratic values and its security interests. The proclivity and ability of the Soviet Union to encourage and exploit revolutionary movements makes all reformist parties and governments suspect to important sectors of public opinion in the developing countries. At the same time American policymakers know that blocking constitutional attempts at reform tends to radicalize the people and thereby plays into the hands of the extreme left.

Vaky illustrates a variety of American policy dilemmas of this nature. Though he couches these in abstract terms rather than in concrete examples, they reflect a wide range of problems faced by U.S. policymakers. These problems, Vaky writes, have led to two opposing conceptual rallying points: (1) The "hands off" approach that would let Latin American affairs develop without United States interference except in cases of clear Soviet/Cuban intrusions; (2) the "hands on" alternative, under which the United States would make itself the arbiter of what is acceptable or unacceptable in internal political conflicts.

Vaky finds serious faults with both alternatives. While in practice, U.S. policies are usually a compromise between these extremes, the implication of Vaky's commentary is that the compromise is usually a hit-or-miss affairs. He offers five guidelines to make the policy mix more rational and more realistic. His most important recommendation, however, beyond the five guidelines, is to cooperate with other Latin American countries and European countries with large interests in Latin America to develop what Vaky terms "a network of multilateral cooperation and governance patterns." He would have this framework of genuine multilateral consultation and cooperation apply to economic policy, foreign assistance programs, human rights, migration, security and conflict settlement.

# ECONOMIC DEVELOPMENT IN LATIN AMERICA: THE MIXED RECORD AND THE CHALLENGE AHEAD

By Karen Morr

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## SUMMARY

Despite the rapid growth in population since the end of World War II, Latin America had made considerable progress in economic growth and in improving the physical quality of life until the prolonged stagnation that began with the sharp downturn of 1980-81 and continued through 1985. Absolute levels of unemployment have increased in the past decade and income distribution remains highly skewed. Greatly sensitive to the business cycle in the industrial country markets for its exports, Latin America has frequently magnified the external shocks with inappropriate domestic policies. This tendency as well as sociocultural factors help explain some of the disappointments in the Latin American development experience to date.

Latin America's debt servicing requirements will remain high until well into the next decade and pose a severe challenge to

meeting future development goals. Steady growth in the industrialized countries will be a key factor affecting Latin America's economic well-being and ability to continue making interest payments on its foreign debt. Domestic policies by reducing imports, increasing exports and reducing inflation have enabled Latin America, with the aid of its creditors, to avoid formal defaults. At the same time, these policies together with depressed prices for Latin America's agricultural and mineral exports slowed economic recovery and compelled governments to reduce social expenditures. A number of Latin American economies have experienced appreciable growth in 1986, but trade balances have decreased at the same time, making uncertain the outlook for sustained growth.

## Development Objectives [1]

Overcoming mass poverty is a fundamental objective of development economics. During much of the period since 1945, economists have focused on achieving rapid economic growth in the lesser developed countries (LDC's) believing that once initiated, growth would become automatic with benefits trickling down to all classes. Despite respectable growth since 1945, the number of people living at the povery level has increased, underutilization of labor is pervasive, and income distribution remains highly skewed.

This disappointing record has led to a refocusing of development strategy and use of other criteria besides growth rates to measure development. Concern with eradication of poverty has spurred quality of life indexes that measure life expectancy, nutrition, literacy, health, sanitation, water supply, and housing. Interest in employment and income distribution has focused attention on changing the structure of LDC economies, including the composition of domestic demand and production, occupational composition of the labor force, and foreign trade and finance. The nature of the tradeoffs among growth, equity, and meeting basic needs is at the center of current theoretical and policy interest. These broader concerns of economic welfare have led many experts to view economic development as a multidimensional study, encompassing a wide variety of subtropics.

Fundamental differences are generally recognized between conditions experienced by the industrialized countries in earlier centuries and by LDC's today. For example, population pressures are more acute than at the beginning of Western industrialization. Socio-cultural approaches to development emphasize the differing social heritages, values and political experiences that may interfere with development of complex economies and institutions. In addition, today's LDC's coexist in a different relationship to rich countries than that prevailing when the latter were industrializing.

Economic development theories each have their own intellectual and cultural biases, reflecting their authors' particular motives, values, and perspectives of history. The "orthodox" paradigm assumes the goal of developing societies to be the greater availability of goods and services for their citizens.[2] Strategies within this paradigm focus on the price mechanism, planning, and attention to social and political variables. The major competing paradigm draws on Marxist and dependency theories and views the goal of the development process as the emancipation of people and LDC's from the control of others. Once societies and nation states bring about this change, growth becomes a desirable objective. Since the 1950's, the economic development of Latin America has been a target of ideological competition between the United States and the Soviet Union, and this competition is presently heightened in Central America.

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[1] This section draws heavily on material from introductory chapters in Bruce Herrick and Charles Kindleberger, "Economic Development" (New York: McGraw-Hill, 1983), Gerald M. Meier, "Leading Issues in Economic Development" (New York: Oxford University Press, 1984), and Charles K. Wilbur, "The Political Economy of Development and Underdevelopment" (New York: Random House, 1984).

## Latin American Inputs

### NATURAL AND HUMAN RESOURCES

Geographically, Latin America extends from the Rio Grande border of Texas and Mexico to the southern tip of South America, plus some Caribbean islands. This area is two-and-one-half times the size of the United States; Brazil alone is larger than the contiguous United States. The region is rich in minerals, with a significant share of the world's bauxite, copper and silver reserves, and has vast agricultural, forestry, livestock, and hydroelectric potential. At the same time, there are large areas of desert, excessive cold and wind exposure, and poor soils that pose serious impediments to permanent settlement.

Discrepancies in natural resources along the region's nations are large. Many Central American and Caribbean nations depend on only one or two crops for the bulk of their foreign exchange earnings. At the other extreme lies Brazil with its exports of diverse primary commodities as well as significant and growing exports of manufactures. Following centuries of slow population growth and labor shortages, the Latin American population has increased rapidly in this century because of falling mortality and continued high fertility. The rate of population growth peaked in the 1960's, averaging 2.8 percent annually in 1960–70. It dropped to 2.7 percent in 1970–80, and is currently estimated at 2.3 percent because of a steady decline in the birth rate.[3] This compares to North American average annual growth rates of 2.2 percent in 1960–70 and 1.8 percent in 1970–80 and world rates of 2.0 and 1.8 percent respectively.[4] Today Latin Americans number close to 380 million, 40 percent more than the U.S. population. The labor force is increasing at a faster rate, reflecting the higher birth rates of previous decades. The demographic pressures for jobs is particularly acute in Central America and in Mexico, Peru, Columbia, and Venezuela where 45–50 percent of the population is under 15 years of age.[5]

Despite the rapid growth in population, considerable progress has been made in reducing illiteracy and improving the physical quality of life. "Between 1960 and the late 1970's life expectancy at birth in the Region increased from 55.7 ot 63.7 years compared to 69 years in European middle-income countries; access to potable water increased from under 40 percent to 66 percent; the population per physician declined from 2.400 to 1,760; access to electricity increased from 46 to over 60 percent." [6] While much of Latin America was illiterate at the turn of the century, today most children attend primary school. Secondary school enrollment in over 35 percent, and between 1960–75, university enrollment increased 600 percent in South America. Rural children in most countries, however, spend less than three years at school.

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[2] These paradigms are discussed in Wilber, op. cit., chapter 1.

[3] Source: *"Statistical Bulletin of the OAS,"* January–December 1984, (Washington, D.C.: Organization of American States).

[4] Source: UNESCO, *"Statistical Yearbook,"* 1984 and 1974.

[5] Source: UNESCO, *"Statistical Yearbook,"* 1984.

Urbanization is integral to much of this improvement in human capital. Among the developing regions, Latin America has the highest level of urbanization. In 1950 about 40 percent of the population lived in towns and cities; in 1980 the urban share was 65 percent.[7] Significant contrasts exist among countries, however. The level of urbanization in Argentina, Chile, and Uruguay exceeds 80 percent; in Bolivia and Haiti, less than a third of the population live in towns and cities. In Brazil, the rural population seems to have declined in absolute numbers according to preliminary census data. This may also be the case for Venezuela and Colombia. In spite of considerable improvements in rural services, the gap between rural and urban living standards remains enormous in most countries.

## SOCIOCULTURAL AND POLITICAL FACTORS

Remnants of traditional society and colonial values survive today in Latin America and run counter to the concept of change and mobility implicit in the development process. Conquest by the Spanish and Portuguese created a social order based on domination, hierarchy, and discrimination against Indian, African and, initially, also, against mixed or mestizo sectors of the population. Iberian political values were authoritiarian and patrimonial with Roman Catholic doctrinal underpinnings. The "less fallible" in society, usually determined by heritage or conquest, ruled because their claim was accepted that they could interpret and execute God's will in a surperior way.[8] The ruler was responsible to his conscience and to God, not to the will of the people who relinquished their autonomy.

Spanish America was settled through the institution of *ecomienda,* a right granted by the Crown that allowed the *conquistadores* to extract labor or tribute from Indians within their domain. Conquered labor made possible the establishment of landed estates and the creation of a privileged class. By 1600 most of the best land had been allocated through royal grants.[9] As disease took its toll on the Indian population, imported African slaves replaced indigenous laborers. A shortage of European women led to mixed-blood children or mestizos who became the dominant ethnic component in most Latin American countries.

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[6] This quote and all figures in this paragraph from Guy P. Pfeffermann, "*Latin America and the Caribbean: Economic Performance and Policies,*" World Bank Reprint Series: No. 228 (Washington, D.C.: World Bank, 1982), p. 140.

[7] Ibid., p. 135.

[8] Thomas Skidmore, "Modern Latin America" (New York: Oxford University Press, 1984) p. 21.

[9] Gary W. Wynia, "The Politics of Latin American Development" (New York: Cambridge University Press, 1984) pp. 8–9.

In most countries, rural society today is still composed of privileged landowners and mestizo peasants. Agrarian reforms have yielded some impressive results in Mexico, Venezuela, Nicaragua, and Peru, but most of the rural poor survive near the subsistence level, lacking capital or technology to develop their land. The traditional estates have been on the retreat, but modern commercial farmers, some of whom are descendants of the colonial aristocracy, have achieved elite social status because of their wealth.[10]

These traditional values of hierarchical class relations and social harmony have reinforced the maintenance over time of elite rule and patrimonial political regimes, in the view of many area experts.[11] Regardless of the period and nature of the regime, Latin American governments have been dominated by a relatively small group of people. Originally the landowning oligarchs, this elite group has expanded over the years to include export-oriented and commercial interests, the higher levels of the public bureaucracy, the military, and industrial and banking groups. Their interests lie in the maintenance of the flexible and paternalistic public order made possible by shared corporatist values, or the belief in a natural hierarchy of social groups, each with its ordained place and own set of prerequisites and responsibilities.

The expansion of the export trade and the influx of immigrants in the late nineteenth century spurred the formation of the middle sectors. Lacking the political clout to transform society, the new strata were co-opted under new patronage networks. Interest-group activity has been regulated by the state, which determines the terms on which recognized groups interact with public authorities.

The Latin American sociocultural context explains, in part, the attitude of resignation and acceptance of their living conditions by most of the rural poor. In addition, lacking the initiative to establish their common interests and separated by large distances, in many cases, the poor are ignored politically. The relatively privileged middle sectors have forged a class consciousness that emulates existing elites. Although fickle in their policies, they have often joined the ruling classes in opposition to the rural and urban poor when they believed their economic interests were at stake.[12]

## Economic Performance

### Background, 1880's–1930's

The region's modern economic history is marked by three rather distinct phases. The open trading stage runs roughly from the 1880's to 1930's. For the next thirty years, import-substitution industrialization provided the impetus for growth. In the 1960's to the present, outward-oriented policies are the driving force behind growth.

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[10] Ibid, pp. 47–51.

[11] Among them is Riordan Roett, Director of the Latin American Studies Program at the John Hopkins School of Advanced International Studies. The following two paragraphs draw on material from his book "Brazil: Politics in a Patrimonial Society" (New York: Praeger Publishers, 1984), particularly Chapter 2.

[12] Wynia, op. cit., pp. 57–58, and Skidmore, op. cit., p. 376.

In the laissez-faire period, 1880–1930, the stimulus and capital for growth came largely from abroad. With its comparative advantage in the production and exportation of agricultural and mineral commodities, Latin America had become by the time of the first world war an increasingly important supplier of raw materials to the rapidly industrializing European and North American economies, with its elites quite content to rely on imports for the manufactured products their economies needed. Foreign investment for railways, ports, mining ventures and commercial plantation poured into the region both before and after the first world war. Great wealth was accumulated by the landowning and business elites. By 1899, for example, Argentina's per capita GDP was estimated at more than half that of the United States.[13] The reduction in both exports and imports during World War I stimulated the growth of light industries, primarily in food processing, textiles, apparel and other consumer goods, but this development languished after world trade came back to normal. The post-war boom in Latin America's exports ended around 1925, but agricultural and mineral exports continued to grow though at a lower rate.

The collapse of world trade caused by the Great Depression devastated Latin American economies and prompted governments to support local industrial development. During the next thirty years, industry became the leading growth sector in most countries. In 1949, following the trade disruptions of World War II, Argentina economist Raul Prebisch of the United Nations Economic Commission for Latin America formally elaborated the inward-looking doctrine of "stucturalism" that remains an important intellectual force in Latin American economic analysis. The doctrine espoused land reform but focused primarily on establishing a protected manufacturing sector as the means to rapid industrialization. This was seen as the way to insulate the economy from recessions caused by unstable world demand for primary products and terms of trade which were foreseen as turning increasingly adverse against countries relying on farm and mineral exports. Governments erected trade barriers, increased public expenditures, and played a broader role in the economy through direct investment, nationalization, regulation, and state planning. The strategy assumed that the growth of the working class and middle sectors plus the promotion of regional economic integration would provide an expanding market for locally produced manufactures.

### IMPORT-SUBSTITUTION INDUSTRIALIZATION, 1930'S–1950'S

Import-substitution industrialization in the 1950's produced very high rates of growth. Brazil, for example, experienced average yearly growth of more than 6 percent in 1947–62, and almost 8 percent in 1956–62.[14] Moreover new industries represented activities in all stages of the production process, with growth most pronounced in transport equipment, machinery, appliances, and chemicals. In the smaller Central American countries, significant expansion of light manufacturing emerged, fostered and protected by the creation of the Central American Common Market.

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[13] Pfeffermann, op. cit., p. 135.

[14] Werner Baer, "The Brazilian Economy," Second Edition (New York: Praeger Publishers, 1983) p. 80.

The industrialization drive of the 1950's increased severe domestic and foreign payments imbalances by the mid-1960's. Unemployment increased as rural-urban migration intensified and relatively few workers were absorbed into capital intensive industries. Inflation was fueled by populist policies that delivered excessive economic benefits to organized labor, industrialists, and the public bureaucracy at the expense of the peasantry and the agricultural sector. Adverse terms of trade and large capital outflows caused mounting balance of payments pressures. Export promotion and diversification were neglected, while industrial production continued to rely on imported capital inputs. Industrialization had been financed in large part by foreign direct investment and loans, and as a result, profit repatriation, loan repayments, and royalties constituted increasingly large outflows.

## OPEN TRADING, 1960'S–1980'S

Foreign exchange constraints and economic stagnation prompted Latin American governments to return to more outward-oriented policies in search of international credit and new investment ties with international companies. Once economic stablization programs were launched, usually under the auspices of the International Monetary Fund, goverments were able to tap into the burgeoning private Eurocurrency market. Industry was the beneficiary of new private and public investment. Domestic savings increased through 1973 with the drop in real wages and reduced inflation rates.

Growth again was impressive, accelerating from an average annual rate of 5.7 percent in 1960–70 to 6.1 percent in 1970–80 (Table 1).[15] The Brazilian economic miracle of 1968–74 posted growth rates averaging over 11 percent annually. With per capita growth rates in excess of 3 percent annually, most Latin American countries were elevated to membership in an international middle class of LDC's. By the mid-1970's the percent of the region's economically active population engaged in agriculture declined to about 35 percent, compared to 47 percent in 1960. Regional manufactured exports achieved an average annual growth of 12 percent between 1960 and 1973.[16]

TABLE 1.—LATIN AMERICA AND THE CARIBBEAN: GROWTH IN ANNUAL GROSS DOMESTIC PRODUCT AND PER CAPITA GROSS DOMESTIC PRODUCT, 1960–85

| | Annual GDP growth rates | | | | | Annual per capita GDP growth rates | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1960–70 | 1970–80 | 1981–83 | 1984 | 1985 | 1960–70 | 1970–80 | 1981–83 | 1984 | 1985 |
| Regional total... | 5.7 | 6.1 | −0.8 | 3.2 | 3.5 | 3.0 | 3.5 | −3.2 | 0.8 | 1.0 |
| Selected countries: | | | | | | | | | | |
| Argentina............. | 4.2 | 2.4 | −2.9 | 2.4 | −4.4 | 2.7 | .8 | −4.5 | .7 | −5.9 |
| Bolivia.................. | 5.0 | 4.5 | −5.8 | 3.1 | 2.1 | 2.2 | 1.8 | −8.2 | 5.7 | 4.3 |

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[15] Source: Inter-American Development Bank (IDB), "*External Debt and Economic Development*" in Latin America, (Washington, D.C., Inter-American Development Bank, 1984) p. 7: IDB, "Economic and Social Progress Reports, 1985 and 1986."

[16] Ibid., p. 124.

### TABLE 1.—LATIN AMERICA AND THE CARIBBEAN: GROWTH IN ANNUAL GROSS DOMESTIC PRODUCT AND PER CAPITA GROSS DOMESTIC PRODUCT, 1960-85—Continued

| | Annual GDP growth rates | | | | | Annual per capita GDP growth rates | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1960-70 | 1970-80 | 1981-83 | 1984 | 1985 | 1960-70 | 1970-80 | 1981-83 | 1984 | 1985 |
| Brazil | 6.2 | 8.6 | −1.3 | 4.5 | 8.3 | 3.3 | 6.0 | −3.7 | 2.1 | 5.6 |
| Chile | 4.2 | 2.5 | −3.1 | 6.3 | 2.0 | 2.0 | .8 | −4.8 | 4.6 | .3 |
| Colombia | 5.2 | 5.5 | 1.3 | 3.2 | 2.8 | 3.1 | 3.3 | −.8 | 2.0 | 1.5 |
| Costa Rica | 5.9 | 5.6 | −3.5 | 7.5 | 1.6 | 3.2 | 3.0 | −5.8 | 4.8 | −.9 |
| Dominican Republic | 5.1 | 6.9 | 3.2 | .4 | −2.2 | 2.8 | 4.3 | 0 | −1.9 | −4.6 |
| Ecuador | 4.9 | 8.9 | .9 | 4.1 | 3.2 | 1.8 | 5.8 | −2.1 | .9 | .3 |
| El Salvador | 5.6 | 3.2 | −4.8 | 1.5 | 1.6 | 2.6 | .2 | −7.6 | −1.3 | −.5 |
| Guatemala | 5.5 | 5.6 | −1.6 | .6 | −1.1 | 2.5 | 2.3 | −4.7 | −2.1 | −3.9 |
| Haiti | .8 | 4.7 | −.6 | 1.8 | 1.7 | −.9 | 2.9 | −2.3 | −.2 | 0 |
| Honduras | 5.0 | 4.8 | −.7 | 2.8 | 3.0 | 1.8 | 1.6 | −3.8 | −.6 | −.2 |
| Jamaica | 5.4 | −.7 | 1.9 | −.4 | −4.0 | 3.9 | −1.8 | .7 | −2.1 | −5.6 |
| Mexico | 7.0 | 6.6 | .9 | 3.7 | 2.7 | 3.6 | 3.4 | −1.7 | .7 | −.3 |
| Nicaragua | 6.9 | .9 | 3.3 | −1.4 | −2.6 | 4.4 | −1.5 | .9 | −4.7 | −5.9 |
| Panama | 7.9 | 5.5 | 3.5 | −.4 | 3.3 | 5.7 | 3.1 | 1.2 | −2.5 | 1.0 |
| Paraguay | 4.4 | 8.6 | .9 | 3.1 | 4.0 | 2.0 | 6.1 | −1.5 | −.1 | .7 |
| Peru | 5.2 | 3.4 | −2.7 | 4.7 | 1.5 | 2.5 | 1.3 | −4.8 | 2.1 | −1.1 |
| Uruguay | 1.6 | 3.0 | −4.5 | −3.3 | .7 | 1.0 | 2.6 | −5.0 | −3.8 | 0.2 |
| Venezuela | 6.1 | 4.2 | −1.2 | −1.4 | −.4 | 2.6 | 1.5 | −3.7 | −4.0 | −3.3 |

Source: 1960-83 data: Statistical Bulletin of the OAS, January-December 1984, (Washington, D.C.: OAS), Table 1. 1984: Inter-American Development Bank. "Economic and Social Progress Reports, 1985 and 1986," Washington, D.C.

Growth slowed in the aftermath of the OPEC oil price hike of 1973-74, but averaged over 5 percent annually in 1973-80, substantially higher than in the industrialized countries. Flooded with OPEC deposits, international banks provided an elastic supply of credit to Latin America that permitted the financing of large government and balance of payments deficits (Table 2). Growth was stimulated largely by public and private consumption expenditures with only modest increases in fixed capital investment.

### TABLE 2.—LATIN AMERICA AND THE CARIBBEAN: INDICATORS OF EXTERNAL INDEBTEDNESS, 1973-84

| | External debt [1] (in billions of U.S. dollars) | External debt service [2] (in billions of U.S. dollars) | Debt service ratio [3] (percent) | Per capita external debt (in U.S. dollars) |
|---|---|---|---|---|
| 1973 | 33.3 | 4.4 | 13.8 | 114.9 |
| 1975 | 60.9 | 11.1 | 23.8 | 199.7 |
| 1977 | 94.1 | 18.4 | 29.6 | 294.1 |
| 1978 | 140.2 | 26.3 | 37.7 | 427.4 |
| 1979 | 172.8 | 35.6 | 38.0 | 514.0 |
| 1980 | 218.4 | 41.3 | 32.7 | 633.3 |
| 1981 | 266.9 | 51.5 | 37.1 | 755.1 |
| 1982 | 298.0 | 63.2 | 51.7 | 823.7 |
| 1983[4] | 319.2 | 66.8 | 64.6 | 861.9 |
| 1984[4] | 352.9 | 69.7 | 60.9 | 931.6 |

[1] Disbursed public and private debt with government guarantee and private without government guarantee. Includes short-term debt.
[2] Interest plus principal.
[3] External debt service as a percentage of the export of goods and services.
[4] Preliminary projections.

Reprinted from Statistical Bulletin of the OAS, January-December 1984.

In 1981-83, however, recession in the industrialized countries and a cutback in international bank credit to the LDC's produced

Latin America's most severe recession since the Depression. Unfavorable world economic conditions—the second OPEC oil price hike of 1979-80, declining LDC export sales, low commodity prices (Table 3) and higher real interest rates—led commercial lenders to cut LDC credit lines. As a result, most Latin American debtors were unable to service growing interest payments on their large debt, and one by one, beginning with Mexico in August 1982, were forced to negotiate temporary payments moratoria that avoided default and disruptions to the international financial system. In exchange for official bridging loans, new bank funds, and IMF credit, debtors undertook economic adjustment programs whose initial impact was recessionary. In 1981-83, Latin American imports were nearly halved, and per capita GDP declined 9.2 percent. For Latin America and the Caribbean as a whole, per capita product in 1983 was at the same level as in 1977, and for almost half the countries, per capita levels declined to those prevailing between 1962 and 1973.[17]

TABLE 3.—LATIN AMERICA AND THE CARIBBEAN: TERMS OF TRADE, 1978-84

[1975=100]

| | Index of terms of trade for basic commodities | Percentage variations |
|---|---|---|
| 1977 | 129.5 | 15.8 |
| 1978 | 101.4 | −21.7 |
| 1979 | 98.3 | −3.1 |
| 1980 | 90.4 | −8.0 |
| 1981 | 73.1 | −19.1 |
| 1982 | 65.3 | −10.7 |
| 1983 | 71.0 | 8.7 |
| 1984 | 72.6 | 2.3 |

Reprinted from Statistical Bulletin of the OAS, January-December 1984.

In 1984 the economies of the region improved considerably over their 1981-83 performance, but the recovery proved short-lived. Per capita GDP for the region as a whole improved 0.8 percent in 1984 as compared to a negative rate of 5.4 percent in 1983. In 1985, per capita GDP for Latin America as a whole rose slightly, to one percent over 1984, but this improvement was primarily the result of Brazil's performance, since that country which accounts for a third of Latin America's GDP was the only Latin American country to experience robust growth in 1985. Even in Brazil, however, per capita GDP in 1985 was still 3.7 percent below its 1980 level. In fact, only two countries had a higher level of per capita GDP in 1985 than in 1980, Colombia (4 percent) and Panama (1 percent) (Table 4). The other 17 countries remained below their respective 1980 levels, and twelve of these were as of 1985 substantially below those levels, ranging from 10 percent to 29 percent below 1980.

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[17] Data for 1960-83: Statistical Bulletin of the Organization of American States, January-December 1984, Washington, D.C. 1984: 1984 and 1985 GDP, Inter-American Development Bank, "Economic and Social Progress Reports," 1985 and 1986.

TABLE 4.—LATIN AMERICA: REAL PER CAPITA GDP, PERCENT CHANGE FROM 1980 TO 1985

| Countries | Per capita GDP 1985 change from 1980 | Countries | Per capita GDP 1985 change from 1980 |
|---|---|---|---|
| Bolivia | −28.7 | Costa Rica | −10.6 |
| Venezuela | −19.4 | Chile | −10.3 |
| Guatemala | −18.3 | Mexico | −6.4 |
| Argentina | −17.4 | Ecuador | −6.0 |
| Uruguay | −16.7 | Dominican Republic | −4.3 |
| El Salvador | −16.4 | Paraguay | −4.0 |
| Peru | −4.4 | Brazil | −3.7 |
| Nicaragua | −11.4 | Panama | 1.6 |
| Honduras | −11.2 | Colombia | 4.0 |
| Haiti | −11.0 | | |

Source: Inter-American Development Bank, op. cit.

Recovery in 1984 in the industrial countries led by the United States, and more realistic exchange rates in Latin America contributed to the improved trade performance of the Latin American economies, judging from data for the eight largest countries. These increased their export 11.5 percent in 1984 over the 1983 level. But the rate of growth of the industrial countries slackned in 1985 and the exports of the eight Latin American countries fell 10.4 percent (Table 5). In 1986, as of mid-year, exports were running at about 15 percent below the level of the first semester of 1985.[18]

TABLE 5.—SELECTED LATIN AMERICAN COUNTRIES: MERCHANDISE EXPORTS AND IMPORTS, 1981–84

[Percent changes based on balance of payments data in dollars]

| | Exports | | | Imports | | |
|---|---|---|---|---|---|---|
| | 1981 to 1983 | 1983 to 1984 | 1984 to 1985 | 1981 to 1983 | 1983 to 1984 | 1984 to 1985 |
| Argentina | −14.3 | 11.0 | 3.7 | −51.1 | −5.3 | −12.0 |
| Brazil | −6.0 | 21.0 | −5.1 | −30.2 | −9.3 | −5.2 |
| Chile | .4 | −1.3 | −.3 | −56.4 | −12.8 | −12.4 |
| Colombia | −6.7 | 8.3 | 9.8 | −.1 | −9.6 | .5 |
| Ecuador | −7.0 | 7.8 | 1.4 | −40.1 | 13.6 | 5.9 |
| Mexico | 10.2 | 10.3 | −11.4 | −67.7 | 36.0 | 20.8 |
| Peru | −7.2 | 2.8 | −4.7 | −29.3 | −7.0 | −6.5 |
| Venezuela | −26.6 | 5.6 | −8.1 | −44.1 | 32.8 | 5.7 |
| Total | −7.9 | 11.5 | −10.4 | −45.6 | 7.1 | −9.2 |

Source: Morgan Guaranty Trust Company of New York, "World Financial Markets (WFM)" October/November 1984, WFM, February 1986, p. 34.

## INCOME DISTRIBUTION AND UNEMPLOYMENT TRENDS

While there is little doubt that income distribution in Latin America is highly skewed, opinion differs on whether inequality has improved or worsened in the postwar period. Empirical evidence is scant and where statistics are available, their validity is questionable. Moreover, economists disagree on how to measure changes in income distribution.

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[18] Estimates obtained from International Trade Administration, Department of Commerce, September, 1986. See Table 6, p. 24.

Some recent studies use labor and wage data to argue that the direction of qualitative changes in the Latin American labor market is incompatible with increased income inequality.[19] These studies point to a substantial decline in agricultural employment, a gain in industrial employment relative to total employment, and rising productivity in the services sector. Migrants appear to have moved up the income scale in the 1970's, and their employment and earnings situations do not differ much from those of comparable city dwellers.

Other researchers use available census data to show a rising concentration in income shares. Alejandro Portes claims that between 1960 and 1975, the top income decile in Latin America increased its relative share by about 1 percent, while the bottom 60 percent saw its income share decline by 1.3 percent.[20] The three intermediate deciles, including organized workers, slightly expanded their relative shares. David Felix looks at four Latin American countries for which income data are available and concludes that rising concentration in income shares has been slight in Argentina since 1945 but larger in Brazil, Colombia, and Mexico.[21]

Conceptual and data problems also make analysis of employment trends difficult and subject to large discrepancies among researchers. Available data generally show that (a) agricultural workers have declined as a proportion of the total labor force in almost all Latin American countries and in absolute terms for a few, including Argentina, Chile, and Venezuela; (b) an increasing share of the labor force is active in the informal urban sectors, and in many countries informal-sector earnings are greater than those in agriculture; and (c) unemployment rates for 1960–75 exhibit ups and downs with little net change over time, but since 1980 statistics show a more definite upward trend.[22] Unemployment has increased sharply in the 1980's because of the recession and economic stabilization policies that have substantially cut government expenditures and investment. As long as growth in the labor force continues to grow at an annual rate exceeding 2 percent, creation of enough jobs will pose an enormous challenge for Latin American governments.

### DOMESTIC POLICIES

While external factors such as higher oil prices, depressed commodity prices, and monetary and fiscal policies of industrialized countries have contributed to macroeconomic imbalances in LDC's, domestic adjustment policies to external shock also have affected growth. A number of studies show the significant contribution of domestic policies to Latin America's inflation and balance-of-payments problems in 1960–81.[23] In its 1984 Annual Report, the World Bank contrasts the variety of LDC responses to the international economic shocks of 1974–81 and concludes that East Asia's LDC policies of export expansion and increased public savings permitted higher growth rates and easier adjustment to the 1980–82 world recession and subsequent cutback in international bank credit. Latin American policies, on the other hand, have contributed to the region's declining share of world trade in the postwar years. (Table 6) That share has fallen from almost 10 percent in 1955 to 5 percent in 1979, while other LDC's share has risen from 15 percent to 19 percent during those years.[24]

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[19] Pfeffermann, "Latin America and the Caribbean: Economic Performance and Policies," pp. 142–144.

[20] Alejandro Portes, "Latin American Class Structures: Their Composition and Change During the Last Decades," Occasional Paper No. 3, School of Advanced International Studies, the Johns Hopkins University, Washington, D.C., May 1984.

[21] David Felix, "Income Distribution and the Quality of Life in Latin America: Patterns, Trends and Policy Implications," Latin American Research Review.

[22] Peter Gregroy, "Employment, Unemployment, and Underemployment in Latin America," Statistical Bulletin of the OAS, October/December 1980, Vol. 2, No. 4. The "informal sector" of developing countries register economic activities small in scale, labor-intensive, and lacking access to simple technologies, capital, and formal school training.

TABLE 6.—REGIONAL EXPORT TRENDS IN PERSPECTIVE

[Percent share of world exports]

| Items (with 1978 share of total regional exports) | 1955 | 1960 | 1970 | 1979 |
|---|---|---|---|---|
| All exports (100): | | | | |
| LAC region | 9.8 | 7.7 | 5.4 | 5.0 |
| Other LDC's | 15.0 | 13.1 | 11.5 | 19.0 |
| Centrally planned | 11.9 | 14.1 | 13.5 | 11.8 |
| Industrialized | 63.3 | 65.1 | 69.6 | 64.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| Food items (38): | | | | |
| LAC region | 20.7 | 17.3 | 15.6 | 15.6 |
| Other LDC's | 22.3 | 19.6 | 15.8 | 14.9 |
| Centrally planned | 7.7 | 11.1 | 9.5 | 5.7 |
| Industrialized | 49.3 | 52.0 | 59.1 | 63.8 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| Fuels and related minerals (31): | | | | |
| LAC region | 26.6 | 23.9 | 13.6 | [1] 8.4 |
| Other LDC's | 29.0 | 32.7 | 45.5 | 57.8 |
| Centrally planned | 13.6 | 18.7 | 16.1 | 17.2 |
| Industrialized | 30.8 | 24.7 | 24.8 | 16.6 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| Non-ferrous metals (4): | | | | |
| LAC region | 14.2 | 11.4 | 10.8 | 8.5 |
| Other LDC's | 19.4 | 17.2 | 16.9 | 12.3 |
| Centrally planned | 8.3 | 10.6 | 11.7 | 12.0 |
| Industrialized | 58.1 | 60.8 | 60.6 | 67.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| Manufactured goods (7) (only SITC 6+8 minus 67 and 68): | | | | |
| LAC region | 0.9 | 0.6 | 1.6 | 1.9 |
| Other LDC's | 7.7 | 7.9 | 9.2 | 14.2 |
| Centrally planned | 10.9 | 11.2 | 8.6 | 6.7 |
| Industrialized | 80.5 | 80.3 | 80.6 | 77.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| Machinery and transportation equipment (5): | | | | |
| LAC region | 0.1 | 0.1 | 0.4 | 0.9 |
| Other LDC's | 0.6 | 0.6 | 1.1 | 3.2 |
| Centrally planned | 15.6 | 16.9 | 13.4 | 12.2 |
| Industrialized | 83.7 | 82.4 | 85.1 | 83.7 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |

[1] Mexico's petroleum export increases are likely to have raised the region's share after 1978.

Notes.—LAC refers to Latin America and the Caribbean, LDC refers to Less Developed Countries. SITC means Standard International Trade Classification.

Source: United Nations Conference on Trade and Development, 1955, 1960, 1970, 1979, "Handbook of International Trade and Development Statistics." Reprinted from Pfefferman, "Latin America and the Caribbean: Economic Performance and Policies," World Bank Reprint Series No. 228.

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[23] See William R. Cline and Sidney Weintraub, "Economic Stabilization in Developing Countries" (Washington, D.C.: The Brookings Institution, 1981).

[24] Pfeffermann, op. cit., p. 141.

The domestic economic policy debate centers on appropriate adjustment measures to correct imbalances without jeopardizing the broader thrust of development goals. The "orthodox" school, including most World Bank and IMF economics, advocate "open" trading and payments regimes which they believe will minimize disequilibrium by encouraging optimal use of available investment resources, preventing supply regidities, and fostering closer balance of demand and supply. "Structuralists," on the other hand, focus on the wide differentiation among productive sectors in Latin American economies and supply bottlenecks that they believe hamper responsiveness to price incentives. Where orthodox economists assume price elasticities, structuralists see inelasticities. They believe that the orthodox emphasis on the price mechanism and demand management though fiscal and monetary restraint impose costs that are disproportionate to the benefits of lower inflation and export-led growth. The latter, in their view, perpetuates a real income transfer of resources from poor to rich countries.

Until the advant of the military regimes in the 1960's and 1970's, most Latin American governments tried to shield their consumers from the impact of external shocks. Although several of the recent military regimes pursued more market-oriented policies, they maintained artificially high exchange rates to make imports cheaper and to reduce inflationary expectations. In most countries, even those under military regimes, government subsidies were still widespread, in the form of price controls on energy, foodstuffs, and housing, below-cost prices on goods and services of state enterprises, and artificially low interest rates. Many costly public investment projects proved uneconomic.

These policies created inefficent production structures and unprecedented government deficits ill-suited to support rising debt service obligations in the 1980's. Overvalued exchange rates undermined export earnings and encouraged capital flight, while government spending and indexation schemes fueled inflation at record levels. Latin America experienced a decline in the efficiency of capital in the 1970's as measured by the incremental capital/output ratio (ICOR), and Pfeffermann uses data suggesting a direct relationship between unfavorable ICOR's and debt servicing problems.[25]

### THE ADJUSTMENT EFFORT

The debate over appropriate domestic adjustment policies has been at the center of demands by the debtor countries and some experts for more lenient IMF adjustment programs.[26] While impressive gains had been made in external accounts by 1983 and 1984, domestic economic performance left much to be desired. All but a handful of countries suffered high inflation rates, and in Argentina, Bolivia, Brazil, and Peru inflation was in the triple digits and accelerating. Domestic savings rates were low, and reform of the sprawling public sectors was proceeding slowly. Although Latin American governments have not ceased to press for a more gradulist approach to correcting economic distortions and for greater levels of external financing, most of them accepted IMF conditions or instituted measures tantamount to these conditions, even if they did not negotiate formal stand-by agreements.

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[25] Ibid., pp. 155–158.

[26] Killick, Tony, et al., "The IMF: The Case for a Change in Emphasis," in Adjustment Crisis in the Third World, Overseas Development Council, Washington, D.C., 1984.

The adjustment efforts improved the external accounts much faster than they curbed inflation. By 1984, the combined trade surplus of the Latin American and Caribbean countries was $31.5 billion as compared to a combined deficit of $11 billion in 1981. The surplus dropped to $25 billion in 1985, but this was still very large by historical standards. As of the first half of 1986, the annualized estimated trade surplus may be as low as $7 billion (Table 7). But as the trade surplus diminished, the inflation picture improved. Consumer price data for the first half of 1986 showed only four countries with rising inflation rates while 16 were experiencing declining rates. Brazil and Bolivia were still affected by very high inflation, but the annualized Bolivian rate of inflation was only about a sixth of the 1985 rate, and the Brazilian rate as of the first half of 1986 was running at about 55 percent of the rate of the first half of 1985.[27]

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[27] In late 1986, however, the anti-inflation program fell apart and by early 1987, the pace of inflation was greater than it had been before the cruzado stabilization program was initiated in February, 1986.

## TABLE 7.—LATIN AMERICAN TRADE, 1981–86

[In billions of U.S. dollars]

| | South American oil-importing or minor oil-exporting countries [1] | | | 3 major oil-exporting countries [2] | | | Caribbean Basin countries [3] | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Exports | Imports | Balance | Exports | Imports | Balance | Exports | Imports | Balance | Exports | Imports | Balance |
| 1981 | 45.0 | 51.1 | −6.1 | 42.8 | 38.1 | 4.7 | 22.3 | 31.7 | −9.4 | 110.1 | 120.9 | −10.8 |
| 1982 | 39.9 | 40.9 | −1.0 | 39.8 | 28.8 | 11.0 | 18.0 | 20.0 | −2.0 | 97.7 | 89.7 | −8.0 |
| 1983 | 41.8 | 33.4 | 8.4 | 39.1 | 17.4 | 21.7 | 18.6 | 25.0 | −6.4 | 99.5 | 75.8 | 23.7 |
| 1984 | 47.1 | 30.8 | 16.3 | 42.0 | 19.8 | 22.2 | 20.0 | 27.0 | −7.0 | 109.1 | 77.6 | 31.5 |
| 1985 | 47.0 | 27.7 | 19.3 | 38.5 | 27.4 | 10.8 | 18.0 | 28.0 | −10.0 | 103.5 | 78.1 | 25.4 |
| 1986 estimate | 45.2 | 31.0 | 14.2 | 27.1 | 20.7 | 6.4 | 16.0 | 30.0 | −14.0 | 88.3 | 81.7 | 6.6 |

[1] Argentina, Bolivia, Brazil, Chile, Colombia, Paraguay, Peru, Uruguay.
[2] Mexico, Venezuela, and Ecuador.
[3] Central America and Caribbean Islands.

Sources: International Trade Administration (ITA), Department of Commerce, "Latin American Trade Review, 1985: A U.S. Perspective". 1986 projections based on information from country offices (ITA), October 1986, for first 6 months 1986, and estimates for ArgentineTreasury Secretary Mario Brodersohn lecture at Overseas Development Council, for Brazil.

The large reduction in the trade surplus in 1986 was largely the result of the steep decline in oil prices which was a grave blow to the region's oil exporters, and particularly to the major exporters. These, and the percentage of total exports represented by their petroleum or refined products exports as of 1985 (shown in parentheses) are as follows: Venezuela (92); Mexico (68); Ecuador (60); Trinidad and Tabago (57); Peru (17); and Argentina (8). Since the petroleum exports represent a relatively small fraction of the latter two countries' exports, Argentina and Peru have been classified with the South American and Caribbean oil-importing countries in Table 8 of this section as the Group of Eight. With the exception of Argentina and Peru, the Group benefited from lower oil prices in 1985 and 1986, but the exports of the eight countries combined appear to have fallen somewhat and their imports to have increased. The combined effect was to lower their balance of trade perhaps about $5 billion or 25 percent less than the trade surplus of 1985.

TABLE 8.—LATIN AMERICA AND THE CARIBBEAN: ANNUAL PERCENTAGE CHANGES IN CONSUMER PRICE INDEX OVER PREVIOUS YEAR, 1979–85

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986[1] |
|---|---|---|---|---|---|---|---|---|
| Countries with rising inflation in 1986: | | | | | | | | |
| El Salvador | 16 | 17 | 15 | 12 | 13 | 12 | 22 | 33 |
| Honduras | 13 | 16 | 10 | 10 | 10 | 5 | 3 | 5 |
| Mexico | 18 | 26 | 28 | 59 | 102 | 66 | 48 | 77 |
| Paraguay | 28 | 22 | 13 | 5 | 13 | 20 | 25 | 40 |
| Countries with falling inflation in 1986: | | | | | | | | |
| Argentina | 160 | 101 | 105 | 165 | 344 | 627 | 672 | 88 |
| Barbados | 9 | 12 | 11 | 10 | 5 | 5 | 4 | 1 |
| Bahamas | | 12 | 11 | 6 | 4 | 4 | 5 | 4 |
| Bolivia | 20 | 47 | 12 | 124 | 276 | 1,282 | 6,453 | 1,170 |
| Brazil | | | | 98 | 142 | 197 | 227 | 126 |
| Chile | 33 | 35 | 20 | 10 | 27 | 20 | 31 | 19 |
| Colombia | 25 | 27 | 28 | 25 | 20 | 16 | 24 | 17 |
| Costa Rica | 9 | 18 | 37 | 90 | 33 | 12 | 15 | 10 |
| Dominican Republic | 9 | 17 | 8 | 8 | 5 | 27 | 38 | 8 |
| Ecuador | 10 | 12 | 13 | 16 | 48 | 31 | 28 | 12 |
| Haiti | 13 | 18 | 11 | 7 | 10 | 6 | 11 | 10 |
| Jamaica | 29 | 27 | 13 | 7 | 12 | 28 | 26 | 16 |
| Panama | 8 | 14 | 7 | 4 | 2 | 2 | 1 | 0 |
| Peru | 67 | 59 | 75 | 64 | 111 | 110 | 163 | 90 |
| Uruguay | 67 | 64 | 34 | 19 | 49 | 55 | 72 | 74 |
| Venezuela | 12 | 22 | 16 | 10 | 6 | 12 | 11 | 9 |

[1] 2d quarter 1986 as compared with 2d quarter 1985.

Source: International Monetary Fund, "International Financial Statistics," November 1986, Washington, D.C.

The achievement of the trade surpluses after 1981 was at the cost of greatly slowing recovery. Per capita GDP fell 9.5 percent between 1981 and 1983. Some recovery took place in 1984 and 1985, but per capita GDP was still eight percent below the 1981 level in 1985. The per capita GDP average for Latin America is expected to grow more in 1986, but it is unlikely that the overall average for Latin America will increase to the pre-crisis level of 1980–81, given the negative growth prospects of the oil-exporting countries.

In the Group of Eight countries, the governments are still trying to restrict imports and maximize exports. But imports have been creeping up. And export prices appear to have fallen further in 1986, reducing export earnings even though the volume of exports increased. Argentina illustrates the difficult time the Latin America countries have increasing their export earnings in the face of depressed export prices. In 1985, Argentina increased the real volume of its exports by 21 percent, but the prices it received were 14 percent lower than in 1984.[28] In 1986, its volume of exports declined about five percent but its export prices fell 12 percent. Although it still maintains tight control over its imports, these are expected to rise in 1986 almost 20 percent above the 1985 level. This is a consequence of increased economic activity which is expected to rise total GDP in real terms about four percent in 1986, the highest rate since 1979. Argentina's export mix is not typical of Latin America's, but the tendency for growth to increase imports faster than exports is true of the other countries as well. This poses a real dilemma for the debtor countries, which must now have to weigh the relative merits of either continuing to strive to restore creditworthiness by keeping up interest payments or going into arrears on these payments in order to increase the imports needed for investment and growth.

## THE DEBT BURDEN AND GROWTH PROSPECTS

The larger Latin American governments with the exception of Peru have up to now given creditworthiness a higher priority than growth. One of the assumptions underlying this choice was that building up export surpluses and keeping up with interest payments on the debt would eventually induce foreign banks and international institutions to resume a more or less normal flow of lending, increasing their exposure 3 to 4 percent annually. Such a flow would permit the Latin American governments not only to resume full debt servicing (amortization plus interest payments) but also permit an increase in imports that would ensure a faster rate of growth. This has not happened as of the end of 1986. The problem, ironically, may well be the slowness of Latin America's recovery from the 1981–83 downturn, a slowness due in part to the policy of keeping up interest payments. Depressed economies do not make for attractive lending and investment opportunities, particularly when they are unable to service their outstanding debt fully.

Underlying the key assumption about the restoration of a normal flow of funds to Latin were several other assumptions which were shared by debtors, creditors and some experts in the early 1980's. These were:

(1) the industrial countries would average an annual rate of growth of 3 to 4 percent;

(2) the industrial countries would not increase their protection against Latin American countries; and

(3) interest rates would decline from the highs of the early 1980's and remain stable at moderate levels.

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[28] The Argentine data in this paragraph were presented by Argentina's Secretary of the Treasury, Mario Brodersohn, in a talk before a seminar held under the auspices of the Overseas Development Council, Washington, D.C., Dec. 3, 1986.

All three assumptions have been more or less borne out up to now, but the expected influx of funds has not occurred. In the discussion that follows the protection and interest rate assumptions are treated first, and the growth assumption last.

The level of protection in the industrial countries does not seem to have materially increased, although Latin American countries have alleged the contrary. Some retaliatory actions have been taken by the industrial countries against Latin American exporting countries deemed to be violating international trade rules as embodied in the General Agreement on Trade and Tariffs (GATT) but these actions are consistent with the GATT, of which most of the Latin American countries are signatories.

With respect to the third assumption, interest rates have come down significantly in the last two years. As a consequence, interest payments on the variable interest rate part of the external debt have been reduced. In 1985, data on nine Latin American countries show interest rate payments were $24.5 million as compared with $26.9 million in 1984, a reduction of 9 percent.[29] Interest rates fell even more in 1986 so the savings should have been even greater. However, since the total external debt of the eight countries increased by about $20 billion in 1985, interest payments on this amount and on whatever increment to the debt may have occurred in 1986 may have offset the savings on the variable rate portion of the debt as it stood at the end of 1984.[30]

Turning to the growth assumption, the industrial countries in 1984-86 increased output at the rate deemed essential for Latin American recovery. Although the industrial economies had barely averaged two percent average annual growth in 1973-83, in 1984 the rate of increase in GDP was 4.8 percent. It dropped to 2.8 percent in 1985 but in 1986, the rate is projected at 3 percent and in 1987 at 3.2 percent. Despite this actual and expected good growth performance, Latin American economic expansion may only now be underway and whether it can be sustained seems unlikely barring an unforeseen and substantial increase in commodity prices or substantial debt relief.

The propensity of Latin American exports to increase in tandem with increased economic activity in the industrial countries was confirmed in 1984, partially confirmed in 1985 and disproved in 1986. The Group of eight countries increased their exports 21 percent in 1984 over 1983 as the industrial countries increased GNP 4.8 percent. In 1985 when the rate of growth in the industrial countries slackened to 2.8 percent, exports from the eight countries remained at about the 1984 level, and imports fell slightly. In 1986, despite the robust growth expected in the industrial countries, exports of the eight Latin American countries are expected to fall slightly, and imports to increase.

Those who have argued from the first that the Latin American external debt could be managed without sacrificing much if any growth might have been borne out if world commodity prices had rebounded as they historically have done when the industrial countries were in an economic upswing. If the industrial countries can sustain the growth of the last few years, commodity prices may rise enough to greatly ease the debt problem of the Latin American countries. In the meantime, however, the present governments may find it politically impossible to go on giving the creditworthiness goal priority over economic growth unless substantial debt relief is given soon.

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[29] Total interest payments for 10 Latin American countries were calculated on the basis of data presented by Wertman, Patricia A., "Current Debt Servicing Capacity of the 'Baker Plan' Fifteen," Congressional Research Service, the Library of Congress, Report 86-641 E., March 31, 1986, p. 22, and "Update", May 5, 1986, p. 22.

[30] Ibid., p. 25, Report 86-641, and p. 19, update.

# DEBT

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## DEALING WITH THE DEBT PROBLEM OF LATIN AMERICA

By Alfred Reifman

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### SUMMARY

With the persistence of the debt problem, various proposals for debt relief are being debated:

In favor of forgiving some of the debt is that: (1) It would relieve the debtor countries of a heavy burden at a time when their economies are depressed and require some kind of assistance, (2) it would have important political benefits to Latin American govenments, and (3) it would be easier to achieve now that the creditor banks are less vulnerable to a write-down of their assets than they have been.

The main arguments opposing debt relief are that: (1) It could be counterproductive, inhibiting the ability of the debtors to borrow abroad in the foreseeable future, (2) it might not help the debtor nations significantly since they are not now paying down the principal of their borrowings, (3) it could raise problems for the lending banks and the U.S. banking system, and (4) the commercial banks cannot be forced to forgive some of their loans.

Some of these objections can be met by recent debt-relief plans. Swaps of debt for equity are an attractive alternative, but only of limited proportions. Subornation of existing debt to any new credits might induce a resurgence of voluntary lending by the commercial banks.

### INTRODUCTION

In 1985, a restrained optimism held that the Latin American debt crisis was behind us and that the problem had been reduced to manageable proportions. Since 1982, there had been a dramatic and steady turnaround in the trade performance of the major debtors, notably Brazil and Mexico, and economic growth had resumed in most Latin American countries. However, by October 1985, when the International Monetary Fund and World Bank met in Seoul, South Korea, it was clear that the improvement in the trade balance was primarily the result of a sharp cut—more than 50 percent—in imports and a harsh compression of domestic output and real wages accompanied by increased unemployment.

This bleak picture led to a renewed search for alternatives to current U.S. policy for dealing with the debt problem.

## ORIGINS OF THE PROBLEM [1]

The international debt problem has both international and domestic causes. Clearly, many of the debtor countries were unable to adjust their domestic policies sufficiently to deal with severe adverse world economic developments—the oil shocks of 1973–74 and 1979–80, the recession of 1981–82, the extremely high interest rates of 1981–82, the persistence of a low volume of exports and depressed export prices. Instead, they borrowed heavily to finance their balance-of-payments deficits.

Those who argue that poor domestic policies are the prime cause of the debt crisis point to the huge budget deficits that had to be financed by borrowing abroad and the more successful adjustment of South Korea and other Asian countries to similar adverse world conditions. They also point to the huge flight of private capital, amounting to over half the external debt of the major Latin American countries, which better domestic policies could have reduced if not averted.

Those who argue that external conditions are the prime cause of the debt problem note that a large portion of the $500 billion increase in the debt of the non-oil developing countries from 1973 to 1982 can be explained by higher oil prices, abnormally high world interest rates and the sharp drop in the value of commodity exports, resulting from economic stagnation and recession in the industrial countries. They point out that the 30 to 40 countries which got into difficulties at the same time could not all have become fiscal irresponsible simultaneously. Finally, with interest rates less than the rate of inflation throughout much of the 1970's, it seemed to make economic sense to borrow at what looked like negative real interest rates.

The truth is that both external and domestic factors were important in producing the widespread debt problem. Moreover, whatever the original causes, the problem has important economic, political and social implications which must be dealt with.

Two schools of thought on the debt problem emerged in 1984–85. The optimists argued that the problem was manageable if satisfactory growth in the industrial countries could be maintained. William Cline of the Institute for International Economics argued that the Latin American countries would be able to pay interest on their foreign debts and achieve a satisfactory pace of economic growth so long as expansion in the industrial countries continued at an unremarkable pace of 2½ to 3 percent per year, and world interest rates and the dollar declined even slightly.

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[1] Summary of a conference on "Dealing with the Debt Problem of Latin America," U.S. Congress. Joint Economic Committee and Congressional Research Service. Committee Print No. 284, 98th Congress, 2d session, 1985, Washington, U.S. Government Printing Office, 1985.

The pessimists, focusing on the risks in the economic forecasts, saw a number of problems. First, economic growth in the industrial countries, particularly the United States, might be weak; it was roughly 2½ percent for all industrial countries in 1986. Second, prices of primary commodities might continue to fall; indeed they have fallen virtually steadily since 1980. Third, a successful export expansion by the Latin American states might be met by increased protectionism in the industrial countries. Fourth, even if such unhappy events did not materialize, and the debt situation of Latin America improved over the remaining years of the decade, the burden would still be heavy, and the creditworthiness of many debtors would remain in doubt, with the result that "voluntary" lending by commercial banks would be limited.

Lawrence Brainard, Senior Vice President of Bankers Trust, put this proposition clearly in 1984: "* * * there's not a single country in Latin America that would qualify for new lending today or perhaps even for the foreseeable future. The risk ratios are too high * * * even on the most optimistic assumption they're not going to get down into the desirable range for the rest of this decade * * * A revival of bank lending is not around the corner." [2]

Much of the cautious optimism of 1985 has been dissipated. A major factor has been the persistent drop in the prices of primary products exported by Latin America and, more particularly, by the sharp drop in the price of crude oil starting at the end of 1985. The fall in the price of oil put a heavy burden on the oil exporters, notably Mexico, where oil accounts for over two-thirds of total exports. To be sure, oil importers in Latin American countries benefit, but the total benefits to the Latin American importers of oil are only one-fourth of the total costs to the oil exporters of the region.[3] Moreover, the benefits are widely distributed among many countries, while the losses are heavily concentrated in Mexico and Venezula.

## U.S. Policy

Since 1982, U.S. policy has been to deal with the problem on a case-by-case basis with two basic objectives in mind:

(1) Restore the creditworthiness of the debtor countries, and, especially since the Baker Plan of 1985, encourage economic growth in these countries; and

(2) Preserve the solvency of the U.S. banking system.

The first objective has not been achieved. Voluntary lending to Latin America has not resumed. Private loans (net) to Latin America were negative in 1985, amounting to minus $2.0 billion; public funding to Latin America was $9.0 billion in 1985.[4]

Economic growth for the median country in the region dropped by 1¼ percentage points in 1985 and per capita incomes remained

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[2] Op. cit., p. vi.

[3] See table 2 of "Developing Country Debt: Implementing the Consensus" in this volume.

[4] World Bank. World Debt Tables, February 1987, pp. 262-265.

10 to 20 percent below the level reached in 1980.[5] The one bright spot was the policy-induced economic expansion in Brazil. But, by 1987 even Brazil's expansion had come to a halt.

On the other hand, U.S. money center banks have been able to reduce their exposure to LDC debts from 290 percent of capital in mid-1982 to 176 percent in early 1986.[6] U.S. banks as a whole have even lower exposure, 106 percent, as most regional banks eliminated their exposure. The threat to the U.S. banking system that was a major concern in 1982 still exists, but it is greatly reduced.

Since mid-1982, Latin American debt problems have been dealt with country-by-country and have involved the unprecedented cooperation of commercial creditors, debtor countries, and official lenders. In return for adopting an economic adjustment program, usually mandated by the IMF and supported with Fund credit, a debtor country obtains financial assistance from creditors in the form of debt rescheduling and new funds. So far this strategy has prevented any major disruption to the world banking system. However, to date the strategy has fallen short in restoring the capacity of the debtor states to achieve healthy economic growth, a reasonable balance of payments, and a degree of creditworthiness that would enable them to borrow from willing lenders abroad.

## THE BAKER PLAN

Recognizing the shortcomings of the original strategy, in 1985 Secretary of the Treasury Baker announced a new approach to deal with the problem. An additional $9 billion of new loans over 3 years would come from the World Bank, the Inter-American Development Bank (IDB), and other development banks. Commercial banks would lend an additional $20 billion over 3 years—$7 billion from U.S. banks, $13 billion from other banks. Finally, the loans would be conditional on economic reforms in the borrowing nations.

The Baker plan is an attempt to deal with the debt problem largely with new lending, while avoiding various proposals for debt forgiveness. But, despite its warm reception, the Baker Plan has not been an obvious success. It has only a Mexican agreement (of September 1986) to its credit. And even this agreement is under attack for two reasons: (1) The commercial banks are unhappy with the provisions that ask them to raise their lending to Mexico if Mexico's economy fails to grow, and the reduced interest rate spread called for. (2) More important, the private and public funds pledged to Mexico alone exhaust over 40 percent of the funds Baker proposed for all 15 heavily indebted countries for 1987.[7] Indeed, the funds suggested by Baker may well be inadequate given the economic plight of the debtor nations though Mexico may not need additional funding in the immediate future.

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[5] International Monetary Fund, Annual Report, 1986, pp. 10 and 11. The median rate of economic growth is the middle of the range—half of the countries did better, half did worse. Use of an average would be dominated by Brazil's superior economic performance in 1985 and, consequently, understate the problem for most countries.

[6] Financial Times International Report, Oct. 10, 1986, p. 1203.

[7] It is ironic that at this writing, February 1987, Mexico has virtually no immediate need for Baker Plan funds. The sharp depreciation of the peso has raised non-oil exports and tight monetary policy has stopped and reversed the flight of capital. The result has been a sharp addition to Mexico's financial reserves in 1986. Proposed import liberalization, which is now feasible, could do much to limit the hyperinflation and stimulate economic growth in Mexico.

The one bright spot has been the shift to more market-oriented policies by many debtor countries, though much remains to be done.

The persistence of the debt problem has led to a wide variety of proposals as discussed by Ms. Wertman elsewhere in this volume. Two of these proposals—debt relief and swaps of debt for equity—are receiving increased attention, as this is being written.

## DEBT RELIEF

In the summer of 1986, Senator Bill Bradley, critical of current policy of piling debt on debt, proposed a program of writing-down the debt and the interest payments of the 15 Baker countries. Without exploring the specific details of the Bradley proposal, the principle of debt relief for developing countries is attractive, but has serious shortcomings.

The case for debt relief is similar to that for the grant portion of Marshall Plan aid for Western Europe after World War II. In addition to loans on generous terms a significant part of Marshall aid was given as outright grants. This was done to avoid burdening the future world economy with repayment of indebtedness since it seemed likely that repayment would put a heavy, if not intolerable, strain on both the debtor and creditor. (The dismal lesson of the attempt to get Germany to pay reparations after World War I was a major factor in opting for grants rather than loans.)

Today, debt relief seems to many observers to be the realistic way to proceed. It would avoid piling new debt on old debt merely to service the old debt, as is now being done. It would reduce the disincentive to investment and reduce the incentive for capital flight as wealthy individuals seek to avoid expected increases in taxes. Moreover, debt relief would not be as threatening to the U.S. banking system today as it was in 1982. Though still high, the exposure of U.S. commercial banks to Latin American debt has been reduced markedly since 1982. Indeed, partial or even complete forgiveness of the debt of some of the smaller borrowers would have a low cost for the banks.

Despite its apparent attractiveness, debt relief has serious shortcomings which William Cline of the Institute for International Economics argues "could do more damage than the disease." [8]

First, a number of debtor countries do not need debt relief. Cline argues that only Bolivia "seems close to needing foregiveness of some of its debt, that other debtor nations would do far better to follow Baker than Bradley."

Second, the commercial banks cannot be required to give up their claims on the debtor countries. The banks might write down the debt on their books but they could, and undoubtedly would, retain their claim on the debtors for the full amount borrowed, that is they would not forgive the debt.

Third, debt relief could be costly for the banks. A significant amount of relief, as proposed by Senator Bradley, would eliminate half of the annual profits of the nine largest U.S. banks and could completely eliminate their profits if the banks were required to set aside loan-loss reserves.[9] The capital of the nine largest banks would be significant cut, yielding higher U.S. interest rates and damaging the interest-sensitive sectors of the U.S. economy. Moreover, the big banks justifiably feel that writing down some loans would affect the perceived value of all their loans to debtor countries.

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[8] The Washington Post, op ed page, July 15, 1986.

Fourth, debt relief, it is argued, would, like any default, damage the creditworthiness of the recipients, making it difficult for them to borrow as the world economy improves. Moreover, debt relief would reduce the pressure for involuntary lending by the commercial banks; they lend now to protect their old loans. Finally, while reducing the debt overhang would increase the ability of the debtor countries to take on new debt, it would reduce the perception of their future willingness to repay—and J.P. Morgan was found of pointing out that willingness to pay was more important than capacity to pay.

Fifth, and perhaps most important, while debt forgiveness could seriously threaten the solvency of U.S. banks, it might do little to help the debtor countries. "Forgiviness of principal is largely irrelevant," writes Paul Volcker, Chairman of the Federal Reserve Board in his letter to Senator Bradley (November 5, 1986), "since recent reschedulings * * * do not call for the amortization of bank debt in the near term." (Of course, a reduction in principal would, presumably, lead to a reduction in required interest payments.)

The major problem country from the point of view of the banking system was Mexico in 1986 and Brazil in 1987. With Mexico in reasonable financial condition, debt relief for those individual countries in dire straits—notably, Bolivia and perhaps several other smaller countries—becomes less of an issue and, indeed, may be realistic. Brazil would remain the major problem.

## A NEW INTERNATIONAL AGENCY

One form of debt relief that was proposed by Professor Peter Kenen of Princeton, and since endorsed by others, is to establish an international agency to buy bank loans at a discount and extend more liberal terms to the borrowing countries. This has attractive aspects. The banks would get rid of loans which are not currently collectable in full or even in large part. The debtor nations would have their debt burden lightened. The cost would be borne by the banks to some extent and by those financing the new institution.

The shortcomings of this variation of debt relief are similar to those enumerated earlier. The banks, it is argued, would not be willing to absorb the large capital loss involved in a write-down and they could not be required to do so. Such losses could seriously damage the solvency of many U.S. banks. Only bad debts would be turned in by the banks or would be sold at more than the market rate of discount. The costs of the new official agency would be large. The credit ratings of the debtors would be damaged, and pressure for further involuntary lending by commercial banks would be reduced or eliminated.[10] And, as noted above, forgiving part of the debt might prove of limited help to the debtor countries.

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[9] Ibid.

It is important to note that the main candidate for debt relief is the payment of interest. Principal repayments on the debt are not being made. They are being postponed in the debt renegotiations which are now regular features of the international financial environment. The Bradley Plan would reduce interest payments to less than the cost of funds to the banks, raising problems for the liquidity of the lending banks, and, of course, the willingness of the banks to lend.

It has been proposed that Japan provide a major share of the financing. Japan is running a huge surplus in its international payments. Such funds could well be loaned to the debtors. However, the foreign exchange earnings accrue to private Japanese business, not to the government. The government would have to increase its contribution at a time when it is running a budget deficit of over 4 percent of GNP, close to that of the United States.

## DEBT-EQUITY SWAPS

Some of the Latin American debt has been converted to equity investment in the debtor country. Citibank has converted almost one billion dollars of its loans to Chile into equity.

Expansion of such swaps has important advantages to both the debtors and creditors. Nevertheless, the amount of such swaps which might be undertaken is quite limited.

The general scheme of debt-equity swaps is as follows: The creditor sells his debt at a discount, for example, to IBM. IBM, however, gets credit in the currency of the debtor nation, for example, pesos in Mexico. IBM would be required to meet specific conditions imposed by the debtor country. The main conditions concern the exchange rate at which the debt proceeds can be converted to equity, and the use to which the local currency proceed must be put—for example, new investment in the debtor country's private firms or in the state enterprises being denationalized.[11]

The advantage to the creditor is that at his discretion he liquidates, at least in part, his claim on the borrower. The advantage to the debtor country is that it reduces its foreign debt with fixed obligations in exchange for a domestic investment, which is desirable and which requires payments to foreigners only when the investment proves profitable and, even then, only under conditions specified by the debtor country—for example, it could require no export of profits for 5 years.

However, the extent of such mutually desirable debt-for-equity swaps is limited for two reasons: First, existing policy on foreign investment plus the requirements and approval process of the debtor governments is cumbersome, and at times, arbitrary. Second, the more swaps that take place, the higher the discount may be and the less attractive the swaps become to the creditor. If this is not a constraint, then the fact that there are limited opportunities for equity investments in many Latin American countries will restrict the amount of swaps than can take place In any event, the process is under way and can proceed at its own pace.

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[10] For a fuller discussion, see "Banking Lending to Developing Countries: The Policy Alternatives," C. Fred Bergsten, William R. Cline, John Williamson, Institute for International Economics, Washington, D.C., April 1985. Policy Analysis in International Economics, No. 10,

[11] For a fuller discussion of the debt-equity swap programs of Brazil, Chile, Mexico and Argentina, see World Financial Markets, Morgan Guaranty Trust Co., September 1986, pp. 11-13.

# WORLD DEBT: THE UNITED STATES RECONSIDERS*

By Christine A. Bogdanowicz-Bindert

It took three years of muddling through crises, near-panics in the financial markets, a million or so jobs lost in the United States, and social unrest in the developing world for the Reagan Administration to recognize the debt crisis for what it is: a long-term economic and political barrier to development that is slowly strangling world economic growth.

Ideology has, at last, given way to pragmatism. At the October 1985 annual meeting of the International Bank for Reconstruction and Development (World Bank) and the International Monetary Fund (IMF) in Seoul, Treasury Secretary James Baker announced that the United States was ready to shift gears and take a more active role in confronting the debt crisis.

Both domestic and international considerations prompted this policy shift. On the domestic front, a slowdown in the U.S. economy has exacerbated the difficulties of American agriculture and manufacturing, thereby stirring protectionist anger in Congress. Protectionism is gaining advocates even though to stem the flow of foreign goods would restrict the exports of Mexico, Brazil and other debtors, and thus prevent them from earning the foreign exchange they need to pay back their loans. The Administration is also increasingly concerned about the political impact in the debtor countries of the strict austerity programs and belt-tighening demands made by creditors.

For months, Fidel Castro has argued for a repudiation of debts, and the newly elected president of Peru, Alan García Peréz, has unilaterally announced that he will not devote more than ten percent of his country's export receipts to service debt. In his dramatic speech to the U.N. General Assembly, he declared, "It is either debt or democracy. * * * We believe the objective must be the unity of debtor countries and a radical change of the current situation." * * *.

Until recently, the Administration has ignored these more "radical" calls, but with Brazil and Mexico pleading for new opportunities for economic growth and Nigeria also questioning internationally imposed austerity programs, the U.S. Treasury fears that a revolt by a major debtor would be enough to threaten most U.S. banks and seriously shake up the international financial system. The case of most immediate concern is Mexico, the third-largest trading partner of the United States. The government there has fallen out of compliance with its IMF program, and thus put its multiyear rescheduling program with the banks at risk. The country has also been ravaged by an earthquake causing at least 7,000 deaths and possibly $4 billion in damages.

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Against this bleak background has come the realization that, although efforts at economy in debtor countries are clearly needed, the question is how to distribute the burden of adjustment more equitably between debtors and lenders.

## II

The contemporary debt crisis is new only in its magnitude. In the nineteenth century, nine state governments in the United States suspended their debt-service payments. Britain and France defaulted on payments to the United States during the 1930s, "on the grounds that their obligations to meet the needs of their people were greater than the legal obligations to creditors." A number of Latin American countries defaulted on their bonds in the nineteenth century and again in the 1930s. As recently as 1953, the United States reduced Germany's debt by two thirds and stretched the repayment over 35 years at a concessional interest rate of only three percent.[1] Although the circumstances were clearly different, this last example shows that the costs of adjustment can be distributed among creditors and borrowers instead of being borne exclusively by the debtors, as is currently the case.

Even during the boom years of 1948–1972, some debtors ran into difficulties and could not service their debts. In these cases, bilateral credits and credits granted by the export agencies of industrial countries were, as they still are, renegotiated under the auspices of the Paris Club, an informal group of creditor governments.

By 1974, developing countries' debt amounted to $135 billion. Ten years later, according to IMF estimates, the combined debt of capital-importing developing countries $830 billion.[2] On average, about 60 percent of this new debt (and over 80 percent in the case of Latin America) was loaned by commercial bankers, and for a practical operational reason. During the 1970s, as billions of petrodollars were deposited in Western banks and financial markets by oil-exporting countries, the deficits of oil-importing countries had to be financed. A solution readily presented itself: take the cash from one group of clients and loan it out to the other. Thus was born the process of "recycling." Bankers also invested billions of dollars in newly rich oil-exporting countries.

Only gradually did creditors and borrowers realize that this solution created a new problem, as most countries continued living beyond their means, without recognizing the grim realities of a new external environment. Huge projects were undertaken, standards of living were given an artificial boost and imports became more attractive than more expensively produced domestic goods. Between 1972 and 1979, the indebtedness of the less-developed countries (LDCs) increased at an annual average rate of 21.7 percent. Furthermore, many developing countries permitted capital to leave their borders by maintaining artifically overvalued exchange rates. Money loaned by banks to Third World governments was reexported by the private sector and invested back in the United States, where real estate or other investments appeared more attractive than local opportunities.

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[1] Cited in Chandra S. Hardy, *Rescheduling Developing-Country Debts, 1956–1981: Lessons and Recommendations*, Washington, D.C.: Overseas Development Council, Monograph No. 15, June 1982, p. 41.

[2] This includes all developing countries except eight Middle Eastern oil exporters.

Credit was cheap in the mid-1970's; the interest rate charged by banks on dollar loans was often less than the rate of inflation in the United States. With interest rates negative in real terms, why not borrow more? Over time, the relative debt-service burden could be expected to diminish. The reasoning was not altogether flawed, providing the loans were properly invested in productive sectors that would yield a return at least equal to the rate of interest. However, as it happened, only about half the credits extended to developing nations were used in productive investments.

When the second oil shock came in 1979–80, the developing countries continued to borrow, and approximately one thousand banks worldwide were eager to oblige. After all, as one leading American banker used to say, "Countries don't go bankrupt." The only worry the banks had to face when interest rates fluctuated greatly was that they might have to pay more for deposits than they were receiving from borrowers. So, after having lent for years at fixed rates, banks began lending on a floating-rate basis during those boom years, effectively passing on the interest rate risk to the borrower.

## III

In October 1979, with double-digit inflation raging in the United States, the Federal Reserve Board decided to adopt the monetarist remedy of tightening the growth of the money supply. As a result, interest rates soared upwards and the U.S. economy plunged into recession. The prices of commodities, which give developing countries their main export revenues, fell sharply as the industrial countries' economies slowed and demand fell. By 1981, bankers switched to shorter maturities that they erroneously believed to be less risky, and eventually started cutting back their loans.

August 12, 1982, proved to be a fatal day. The finance minister of Mexico, Jesus Silva Herzog, made three phone calls to announce that Mexico had run out of foreign exchange reserves and could not continue to meet its external obligations. Herzog's three appeals for help went out to the managing director of the IMF, Jacques de Larosière, to Donald Regan, then treasury secretary, and to the chairman of the Federal Reserve, Paul Volcker.

Mexico had had problems before, in fact as recently as 1976, and other debtors had run out of foreign exchange at one time or another since 1974, most notably Zaïre, Zambia, Senegal, Jamaica, Peru, Poland and Turkey. However, never before had any country's debt problem reached the magnitude and complexity of that which Mexico now faced. Mexico's total debt exceeded $80 billion and almost 30 percent was due within one year. Moreover, the exposure of U.S. banks alone was enormous, equal to 44 percent of the equity of the country's nine largest banks. It was thus clear that the Mexican crisis, if not handled properly, would create a panic in the financial markets and have serious consequences for the world economic and financial system.

The response was a remarkable cooperation between governments and banks, orchestrated jointly by the IMF and the U.S. government. The assembled rescue package provided for postponing the payment of principal, for new flows of capital and for a drastic belt-tightening program in Mexico. In November 1982, Mr. de Larosière summoned the top executives of the leading commercial banks and, in an unprecedented move, told them flatly that the IMF would not approve a stabilization program for Mexico unless the bankers first agreed to restructure over $20 billion of Mexico's debt and provided $5 billion more in new loans, a seven percent pro rata increase in the exposure of Mexico's creditor banks.

The Mexico action set two important precedents. It propelled the IMF to the forefront of the debt crisis, and it set the pattern for all subsequent reschedulings. Since 1982, 38 countries have rescheduled their debts or are in the process of doing so. South Africa is the latest to join the long list of these countries, whose combined debt is estimated at about $550 billion.

The rationale for extending new credits while postponing the payment of principal is that a debtor-nation needs economic breathing space to succeed in increasing domestic savings and to accelerate the growth in production and exports needed to generate foreign exchange. But this scenario works only if one assumes a favorable world economic environment, namely three percent or more in economic growth and a standstill on protectionist tendencies in industrial countries. For debt-service burdens to become more manageable, real dollar interest rates would have to be lower. Finally, banks would have to be prepared to provide new credits, increasing their exposure at an annual rate of five to seven percent from now until the end of the decade.

Since August 1982, a general pattern for dealing with the debt crisis has emerged. When bankers sit down to negotiate with debtors they use Mexico as a yardstick. They claim there now exists a "rescheduling market" in which the terms and rescheduling conditions for each debtor are determined on the basis of its credit rating relative to that of Mexico. Although logical from the bankers' point of view, this means that those debtors in the worst condition have to pay the highest prices for assistance. Whereas banks, pressured by the U.S. government and the IMF, have lent additional billions to big debtors such as Mexico and Argentina, smaller debtors that do not individually threaten the international financial system have been basically neglected. In sub-Saharan Africa, for instance, only the Ivory Coast has been granted long-term fresh money by the commercial banks in the context of rescheduling operations.

In 1984, Mexico improved the terms and conditions of its own rescheduling over the package of 1982, and most Latin American debtors derived some benefit from this precedent. But sub-Saharan African countries such as Senegal, despite their more difficult economic situations, did not benefit at all, and their rescheduling packages have typically been more stringent than those accorded even to small Latin American debtors. For African countries, banks have not rescheduled anything but arrears and debt payments falling due in one or two years. This means that every year creditors and borrowers must reconvene at the negotiating table.

Planning becomes very difficult; the future conditions that may be required for the rescheduling of debts owed by African nations remain uncertain. It should also be noted that the Philippines and Yugoslavia, by contrast, have typically been treated more like the big Latin American debtors; developments in both of these countries could represent a threat to U.S. security interests, as well as to the international financial system, if things were to turn sour.

## IV

During 1983-84, the world economic environment proved to be somewhat kinder to Third World debtors than anticipated. Growth within member countries of the Organization of Economic Cooperation and Development averaged more than three percent, fueled by very rapid improvement in the U.S. economy, which grew at 6.8 percent in 1984. The record American appetite for imports helped absorb expanded exports from debtor nations. Virtually all the increase in exports from Latin America between the first quarter of 1983 and the first quarter of 1985 went to the United States.

But the gains made in 1984 concealed some troubling underlying trends for the world economy. General commodity prices linger at an unprecedented low level. Typically, in a period of relatively strong economic growth, commodity prices should increase as demand becomes greater. In fact, however, dollar prices for non-oil primary commodities were about 11 percent lower in 1984 than in 1980. Oil prices, critical for countries such as Venezuela, Nigeria and Mexico, dropped 16.6 percent from 1981 to 1985.

Although nominal interest rates have declined from their peak in 1980-81, they remain about six percent higher than inflation, making the cost of servicing debt extremely high in real terms. Finally, the rate of increase of new credits has been shrinking as banks have been relucant to lend to those LDCs that are encountering debt-servicing difficulties. The only exception to this trend has been multibillion-dollar packages of credits organized under the auspices of the IMF. But even taking into account these arrangements, the rate at which new credits have been granted comes nowhere near satisfiying the call of the IMF and the Bank for International Settlements for a five to seven percent annual increase.

The IMF predicts that the main industrialized countries will grow in 1985 at a rate of 2.8 percent, and the United States at only 2.6 percent. Furthermore, non-oil primary commodity prices are forecasted to decline by as much as 11.2 percent in 1985. Under such constraints, and coupled with a rise in protectionist tendencies, it will be difficult for debtor countries to increase their exports.

Against this background, the debtors' general capacity to implement strict austerity programs has been remarkable. According to the IMF, capital-importing countries reduced their current account deficits from $112.5 billion in 1981 to $37.9 billion in 1984, and this despite ever-increasing interest bills as principal went unpaid and new credits boosted the total amount of debt. Looking at the merchandise trade balance alone, these countries' efforts appear even more impressive: moving from a trade deficit of $65.1 billion in 1981 to an aggregate surplus of $15.2 billion in 1984.

This turnaround was the result of harsh austerity measures intended to reduce consumption. Under the auspices of IMF programs, developing countries devalued their currencies, phased out subsidies, increased prices of public utilities, restrained wage increases, tried to reduce the size of the public sector, increased interest rates, and slowed down the rate of credit growth. Trade and investment practices were somewhat liberalized and more market-oriented policies were adopted. In some countries, serious efforts to convert large parts of the public sector to private ownership were undertaken. Some countries—Mexico, Argentina, Chile, Costa Rica, Ecuador and Ghana—have done much more than others, where rhetoric and reality have not always matched.

But the record of these IMF-inspired programs is not altogether positive. A large portion of the trade account improvement was due to sharp curtailments of imports, a step clearly unsustainable over a longer period of time. Exports by debtors, which got an initial boost from currency devaluations, are beginning to contract in some countries, such as Mexico and Brazil. In others, for example Argentina, the growth of exports is stagnant. Competition among LDCs for export markets is getting tougher, especially as world economic growth slows down.

Production in most developing countries has also been runing below capacity, partly because of constraints on the importation of raw materials and equipment, partly because the private sector has been left with insufficient funds with which to operate. Huge currency devaluations, and thus increased costs of material, labor and debt have depleted working capital. In addition, investments needed to maintain infrastructure—roads, telephones and other services—have often been postponed, hampering production efficiency.

Within the developing countries, high inflation and slow growth have become the norm. According to the IMF, inflation in Africa in 1981 averaged 21 percent, and still amounted to 20 percent in 1984. And in Latin America, despite a short-lived improvement in some major debtor countries, inflation for the area as a whole more than doubled during the same period, averaging a staggering 117 percent in 1984. In both Africa and Latin America, inflation will probably be higher in 1985 than in 1984.

Economic growth in sub-Saharan Africa continues to lag seriously behind the high rate of population increase, further reducing already meager per capita income. Not until 1990, at the earliest, will Latin America recoup its 1980 standards of living. Unemployment and underemployment are widespread. Health and education services have declined dramatically; malnutrition and infant mortality have increased. The average citizen in developing countries today consumes fewer calories daily than in 1975.

With double-digit unemployment, more than half the working population holding only part-time jobs, and no social security safety net, the governments of debtor nations are clearly sitting on a social powder keg.

The IMF is often unfairly blamed for the harshness of these austerity programs. The uncertainty and shortage of funds received from both private and official sources is what constrains these countries' growth. The IMF staff has to deal in the real world, in which commercial banks are unwilling to lend additional money following a decade of mistaken enthusiasm and the U.S. Congress and public are reluctant to support increased multilateral and bilateral financial assistance. The IMF was created to finance *temporary* balance-of-payments problems. Long-term development and project financing was to be the responsibility of its sister organization, the World Bank.

The World Bank has been accused of sleeping soundly through the events of the last three years. That too is unfair. The Bank has been seriously hampered in its capacity to innovate and launch new projects by the skeptical attitude and suspicion of its main shareholder, the U.S. government. Some members of the Reagan Administration considered the World Bank too "socialist."

## V

This was situation that greeted James Baker when he became secretary of the treasury in January 1985. Ever the pragmatist, it took him only a few weeks to understand the gravity of the debt crisis. Mr. Baker was concerned about the stability of the U.S. banking system and possible repercussions on the world financial markets. He also saw the negative impact of prolonged stagnation in debtor nations on U.S. exports, and thus on employment. The possible political ramifications of a slow disintegration of debtor nations must have also been on his mind when he determined that the United States would take a more active lead.

On October 1, he and Mr. Volcker met with the chairmen of America's major banks, in itself a highly unusual step. The bankers were informed of Washington's new game plan and were sounded out as to the amount of credits they could provide to debtor nations. On October 8, Mr. Baker took the rostrum at the IMF-World Bank annual meeting in Seoul and told 9,000 delegates from 149 countries that the debt crisis could only be solved by an even closer cooperation of all parties concerned, more money from commercial banks, an enhanced role for the World Bank and more growth in the developing world.

The Baker declaration is significant. For the first time the Administration officially recognized that the debt crisis is here to stay, and that austerity has to give way to growth. Furthermore, the chief financial officer of an Administration hitherto hostile to the World Bank stated that the Bank was ideally suited to provide support for medium-term economic reforms.

The commercial banks were asked to continue to lend to 15 heavily indebted countries, and to increase their exposure by at least 2.5 percent per year. This falls between the older proposals for five to seven percent growth in credits and the current reality of no spontaneous credit growth. In total, the banks will be asked to contribute $20 billion over the next three years. The list of countries includes Argentina, Brazil, Mexico, Venezuela, Uruguay, Chile, Ecuador, Colombia, Peru, Bolivia, Yugoslavia, the Philippines, Nigeria, the Ivory Coast and Morocco. Mr. Volcker, who helped in the design of the plan, has himself been urging banks to pledge these additional funds.

In addition, Mr. Baker called for the World Bank and other development banks to provide more assistance to debtor nations. Both the Inter-American Development Bank and the World Bank were asked to increase their disbursements to major debtors by roughly 50 percent, to $9 billion. The total package would thus amount to $29 billion.

Mr. Baker appealed to the World Bank to streamline its operations in order to reduce the time necessary to negotiate a program with borrowers and hence speed up actual disbursement of loans. He also proposed that the Bank provide direct assistance to the private sector of indebted countries.

Two other specific schemes were endorsed by Mr. Baker: the World Bank's Multilateral Investment Guarantee Agency is to provide guarantees for direct investments in developing countries, and $2.7 billion is to be recycled by the IMF Trust Fund, a facility extended to the IMF's poorest members in the 1970's. Debtors will have to make firm commitments to further strengthen their economies by adopting additional market-oriented economic policies, relying more heavily on supply-side actions such as tax and labor reforms, transference of inefficient state enterprises to the private sector, liberalization of trade practices and adoption of policies to attract more foreign investment.

Both bankers and debtors have responded cautiously to Mr. Baker's program. Bankers are wary of lending more money to countries already strapped for cash without receiving explicit guarantees from the governments of industrial countries. Most debtors are concerned about additional new conditions that will be imposed and by the prospect that the IMF and the World Bank will combine forces against them. Small and poorer debtors are concerned about being left out.

## VI

An increased role for the World Bank is clearly needed. But unless the United States openly backs both an increase in the World Bank's capital and changes in its lending practices—which so far it has refused to do—the Baker plan will fall short.

The World Bank should take a larger role in reviewing member countries' investment strategies and advising on structural reforms needed to increase production, exports and employment in the medium and long term. It has a unique expertise and a highly qualified staff in this field, and in fact, has already started working in this direction.

Conservative lending practices need to be relaxed, especially if increased capital contributions continue to be resisted by key shareholders. For example, the ratio of World Bank loans to its capital could be increased from its current conservative level of one to one. (This "gearing ratio" is typically twenty to one for U.S. commercial banks.) More financing could also be provided if the Bank switched emphasis from its traditional role of lending for specific projects to more structural adjustment loans. In cases where local currencies are difficult to mobilize, the World Bank should be permitted to lend one hundred percent of the cost of a project. Finally, the World Bank should put more emphasis on low-cost housing programs; such programs have a welcome democratic angle, usually have a very high local content, are low cost, and are typically very labor-intensive and thus will create new employment.

The U.S. proposal encourages World Bank co-financing with commercial banks, and this is already being tried in various forms. The World Bank may participate directly with commercial banks in syndicated loans; or it may join commercial banks in offering a floating-rate credit with level payment similar to domestic mortgage arrangements in the United States. In the latter case, borrowers are in effect protected against rising interest rates since the periodic payments remain constant. When interest rates increase, a large proportion of each debt-service payment is taken up by interest, and hence principal is repaid more slowly. The World Bank then refinances any principal still outstanding at the end of the loan's original life, and thus ensures banks of timely payments. This creates, in effect, a cap on interest.

Another, and so far less frequently applied, alternative is for the World Bank to guarantee portions of a loan, particularly in the tail end of the maturities due. This guarantee applies to principal only. In order to obtain such a guarantee, bankers pay a fee which effectively reduces their rate of return. Such guarantees in fact reduce the risk that a debtor country will default, because the commercial banks are more willing to lend the amounts required. Provided such financing and guarantees are coupled with strict monitoring of the economic performance of the country, the chances of success increase significantly.

Collaboration between the World Bank and the IMF, as proposed in the Baker program, is not a new idea. Informal contacts have always existed between the two institutions, located across the street from each other in Washington, D.C. Their boards of governors hold concurrent annual meetings, and both institutions have evolved toward greater similarity to one another. The IMF, conceived as a vehicle for temporary relief, has adopted longer loan-adjustment periods, while the World Bank, in 1980 adopted measures to encourage macroeconomic reforms and supply-side measures. The IMF has also become operationally interested in investment and production and often asks the World Bank's staff for an evaluation of a country's investment program. The World Bank and the IMF have tried to coordinate more closely their approach to member countries and, in some cases, have undertaken joint missions.

But despite all the talk of cooperation, serious differences remain. The IMF generally confines its policy recommendations to macroeconomic policy; as such it operates more rapidly than the World Bank, which is more concerned with the details of how an economy functions. For example, the IMF typically recommends that the aggregate budget deficit be reduced, while the World Bank recommends specific cuts.

The fundamental point is that Mr. Baker's scheme can only work if it is lubricated with enough credit. The goals in his proposal are modest. Yet, even the proposed 2.5 percent increase in bank lending to the 15 debtors on his list may prove difficult to mobilize. The idea, floated for the first time in Seoul, of letting small banks opt out of new Third World exposure althogether, leaving about one hundred international banks to shoulder the burden of future lending, is anathema to most major banks. Even the largest banks, mindful of their stockholders, have so far been reluctant to guarantee any plan for stepped-up lending, asking instead for concessions from the Treasury and banking regulators.

So far, Washington has insisted that no special treatment would be granted for these loans. Instead, Mr. Baker argues that banks should cooperate in their own interest: "They have got loans in trouble. It's possible that reflows will make bad loans into good loans," he stated before the House Banking Committee.[3]

European banks would also perfer not to lend more money. They would rather capitalize interest; a practice that goes agaisnt U.S. regulations. Banking and tax legislation in a number of European countries encourage the establishment of sizable loan-loss provisions; in addition, some countries have developed generous accounting rules which allow banks to form what are called "hidden reserves" that amount to the retention of untaxed cash. Thus, most European banks are sufficiently cushioned to absorb potential losses, in contrast to their U.S. counterparts. This is especially significant since at least one third of the $20 billion in new loans is to be provided by European banks.

## VII

The United States must now show the bankers that it means business and gain the cooperation of other industrial countries. Export credit agencies need to increase their lending and guarantee programs; bilateral assistance should be increased significantly. Japan, which has the world's biggest current account surplus, clearly has a role to play, for its banks have the second-largest exposure in Latin America.

The Reagan Administration is considering Mexico as a candidate for trying out its new stepped-up international debt strategy. Mexico's gross foreign financing requirements for the rest of the year and 1986 are usually estimated at about $7 billion, and some analysts' estimates are much higher. Mexico clearly must remain a top priority; but with only $20 billion available for the debtors on Mr. Baker's list, will there be enough left for others? And are the others to wait on the sidelines while the strategy for Mexico is worked out among the concerned parties?

Mr. Baker's strategy is geared mainly toward dealing with the big debtors, those few that can hope for a resumption of voluntary credits. But what is the strategy going to be for smaller and poorer countries which should never have borrowed so much on commercial terms in the first place? Unless explicitly guaranteed by the World Bank or the U.S. government, credits to these countries will remain scarce.

Even the small debtors' relationship with the IMF is strained. Nineteen of these countries had arrears of about $400 million outstanding to the Fund at the end of August 1985. There must be a mechanism to clean the slate. These smaller countries need adequate financing if structural changes and investments in quick-yielding projects are to be implemented. One way of doing so would be to consider a formula which would establish a country's debt-service payments as a function of its export receipts and non-tied capital inflows. During the 1970's, a debt-service ratio of 20–25 percent was considered very high. Today the debt-service ratios of most small debtors are in the 40–50 percent range (even after rescheduling takes place). But the fact that such levels have become a sort of norm does not mean that they are sustainable. Under a flexible formula a country would allocate a portion of its foreign exchange receipts to debt service. The details of the formula and the exact percentages should be established on a case-by-case basis. The difference, if any, between the payments dictated by the formula and the interest actually due could be capitalized.

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[3] The New York Times, Oct. 23, 1985.

To stimulate growth, an additional portion of debtor countries' export receipts could be set aside in a trust fund either in local currency or in foreign exchange. The debtor government would use the money in this fund to make investments in productive sectors, to complete priority projects, and to inject capital into the private sector. In return for the reduction in debt-service payments, the debtor would allow a mechanism to be put in place to monitor the allocation of money in the trust fund, to ensure that it is invested appropriately.

Promising though it may sound, however, this scheme does not address the fundamental problem of many debtors: their debt is growing faster than their net export proceeds; they will simply never catch up. Reducing the rate of interest to be paid, whether by setting ceilings on the percentage of foreign exchange allocated to debt service or by arbitrarily setting the interest rate below the market level, will not suffice.

For these countries, the banks and industrial governments should consider writing off part of the debt. There would not be any major consequences for banks or governments provided that countries benefiting from such a "radical" treatment do not present a risk to the system. The difficulty of such an approach is to find criteria to determine where the borderline should be drawn. In fact, a number of banks have already written down, though they have not written off, a sizable portion of their exposure to small debtors. These countries still have a contractual obligation to pay interest on the total amount of debt outstanding. A write-off by the banks for some countries would obviously have to be reviewed carefully, to examine the possibility that the debtor could further reduce imports, adjust its economy, or generate additional exports. To avoid any abrupt reduction of bank earnings, U.S. regulators and Congress might have to allow an extended period for the banks actually to write off such loans. A clause to guard against free rides would have to be included. Such a clause would stipulate that in the event a country enjoys a sudden, unexpected increase in foreign exchange receipts, for example because of a jump in copper prices, debt cancellations would be reviewed.

On balance, the U.S. recognition that the debt crisis is threatening the international financial and trade system as well as the political stability of debtor nations is a giant step in the right direction. Mr. Baker's bold initiative to launch a "Program for Sustained Economic Growth," with the U.S. government playing a more active role, needs some time to be fully assessed. But unless funds are mobilized to facilitate the process, the appeal for more cooperation among creditors and debtors may give way to a more confrontational stance. Expectations have been raised high; now they have to be fulfilled.

# MANAGING THE LDC DEBT CRISIS*

By Jeffrey Sachs

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## SUMMARY

Since the early 1980's, major defaults on the huge debt of the developing countries have been averted by a combination of measures: debt maturities have undergone rescheduling, the debtor countries have contracted their economies to cut imports and increase exports, and the creditor countries have provided just enought refinancing to enable the debtor countries to keep up their interest payments and maintain minimal levels of imports.

The austerity measures taken by the debtor countries, the growth of the industrial economies, and lower interest rates were expected to bring about recovery and growth long before now in the debtor countries. Owing, however, to falling prices for most of the primary commodities Latin America exports, the Latin American economies with few exceptions have not been able to recover their late 1970–early 1980 levels of economic activity.

For these economies to grow and thereby alleviate the social and political strains caused by prolonged economic stagnation, three measures are proposed: (1) Debt relief should be provided on a selective basis to the countries that have suffered major declines in per capita real income since 1980; (2) Precedence in payment of interest and principal should be given to new lenders over old lenders; and (3) The creditor countries should stipulate to the governments of the debtor countries that the burdens of adjustment should be distributed more equitably than at present, the wealthier groups in these countries having protected themselves by capital flight and low taxes, while the poor have suffered heavily from high inflation and economic austerity.

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## INTRODUCTION

The debt crisis of the developing countries is now entering its fifth year. Since August 1982, when Mexico declared its inability to service it debts, more than forty developing countries have experienced crises in external finance.[1] Several earlier Brookings studies analyzing the debt crisis have focused on the origins of the crisis, the market responses to it, and the relationship of the industrialized nations' macroeconomic policies to the prospects of the debtor nations.[2] This paper has a different focus: the management of the debt crisis by the creditor governments, especially the United States.

Looking back at the past four years, one can discern a basic strategy on the part of the United States, Japan, and other creditor governments. For them, the debt crisis opened up the prospect of a major world financial crisis. With the world's largest commercial banks holding claims on the debtor countries that typically exceed 100 percent of bank capital, any wholesale repudiation of debt by the leading debtor countries would threaten the solvency of these banks and push the world economy into treacherous and uncharted waters. The strategy of the creditor governments therefore coalesced around one principal goal: maintaining the servicing of commercial bank claims by the debtor governments.

Most foreign and economic policy initiatives on the debt by the creditor governments and the multilateral institutions have been designed with that objective at the core. The creditor governments have used their leverage to make sure that reschedulings of bank debts owed by foreign governments involve neither an interruption of interest payments to the banks nor a reduction in the present value of the debtor countries' future obligations to the banks. In effect, the creditor governments have endorsed debt reschedulings rather than debt relief, where relief signifies any arrangement, such as below-market interest rates, forgiveness of principal, or repurchase of debts by the debtor country at below par, that reduces the present value of contractual obligations of the debtor country. Although banks have written down the value of some sovereign loans on their own books, sometimes at the behest of regulators or auditors, they have not granted relief to the debtor governments.[3]

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[1] The World Bank's study "Development and Debt Service: Dilemma of the 1980s," table 2, page XIV, in World Debt Tables: External Debt of Development Countries, 1985-86 ed. (World Bank, 1986), lists thirty-eight countries that have engaged in multilateral debt renegotiations during 1982-85. Several more countries that have entered IMF standby arrangements because of debt-servicing difficulties have not engaged in multilateral debt renegotiations. The countries in the World Bank list are Argentina, Bolivia, Brazil, Central African Republic, Chile, Costa Rica, Dominican Republic, Ecuador, Equatorial Guinea, Guyana, Honduras, Ivory Coast, Jamaica, Liberia, Madagascar, Malawi, Mauritania, Mexico, Morocco, Mozambique, Nicaragua, Niger, Nigeria, Panama, Peru, Philippines, Romania, Senegal, Sierra Leone, Somalia, Sudan, Togo, Uganda, Uruguay, Venezuela, Yugoslavia, Zaire, Zambia.

[2] See Carlos F. Diaz-Alejandro. Some Aspects of the 1982-83 Brazilian Payments Crisis," BPEA, 2:1983, pp. 515-42; Diaz-Alejandro, "Latin American Debt: I Don't Think We Are in Kansas Anymore," BPEA, 2:1984, pp. 335-89; Jeffrey D. Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia, "BPEA, 2:1985, pp. 523-64; and Rudiger Dornbusch, "Policy and Performance Links beteeen LDC Debtors and Industrial Nations," BPEA, 2:1985, pp. 303-56.

[3] In some cases, explicit relief has been granted to private borrowers in the debtor countries, usually when the loan involves a single bank and a single borrower. However, with respect to private-sector loans, the commercial banks have repeatedly pressed foreign governments to take over or at least guarantee the private-sector debts on an ex post basis, after which they are treated like sovereign debt.

Write-downs are an internal matter; relief is a matter between creditors and debtors.

The private banks have sometimes been encouraged by creditor governments to make new loans, but in amounts significantly less than the interest that they receive from the debtor countries. The new loans have almost always been conditioned on an agreement between the country and the International Monetary Fund on a high-conditionality standby loan, under which the debtor government declares its intent to pursue austerity measures. Finally, various official lenders have made new loans, some of which have also been conditioned on policy reforms in the debtor countries. The creditor governments have sometimes extended new loans to the major debtor countries (as with a "bridge" loan to Mexico in the fall of 1986) to enable them to service their bank debts.

The strategy has so far succeeded in keeping the foreign debts serviced, as is evident from data in Table 1 on the net resource transfer to the debtor countries during the past five years. Since 1982, the net transfer—the net flow of new capital into the debtor countries minus the repayment of interest and profits on foreign investment—has been negative because the debtors have paid back much more than they have received in new loans. For Latin America, the negative net resource transfer since 1982 has totaled more than $95 billion. Yet the years under the debt crisis and IMF-style austerity programs have been ones of extreme economic hardship and declining living standards in most of the debtor countries. In some of the worst cases, the declines are shocking, with 1985 real wage levels down to 50 or 75 percent of 1975 values. Social and political dislocations have been profound.

Since the onset of the debt crisis, there have been several waves of optimism and pessimism in the creditor countries as to whether the fundamental debt strategy would succeed. Some of the economic indicators prompting these swings in mood are shown in Table 2. After the jolt of Mexico's financial distress in mid-1982, the immediate concern was whether the debtor countries would simply renounce their obligations. Creditors were thus delighted with the events of 1983, when the major debtor countries chose to maintain debt servicing despite an extreme fiscal crisis and plummeting economic activity. Creditors applauded the sharp swings towards trade balance surplus and argued that the accompanying sharp fall in gross national product in those countries was unavoidable but temporary. As seen in the table, among the group of countries with debt servicing problems, real per capita GDP in 1983 fell by 4.8 percent, while the trade balance swung from a $6 billion deficit in 1982 to a $22 billion surplus in 1983. In the western hemisphere, the fall in real per capita GDP was more than 5 percent. Creditor optimism increased in 1984 when the world economic recovery, led by the United States, accelerated. The major debtor countries experienced per capita growth once again (though African per capita GDP continued to fall), albeit at a modest rate, and their terms of trade improved. Creditors talked as though the debt crisis were behind them, and they began reaching for long-term solutions through multiyear rescheduling agreements with the major debtor countries.

## TABLE 1.—NET RESOURCE TRANSFERS TO LATIN AMERICA, 1981–85

[In billions of dollars]

| Year | Net capital inflow | Minus interest repayments and foreign profits | Equals net resource transfer |
|---|---|---|---|
| 1981 | 49.1 | 27.8 | 21.3 |
| 1982 | 27.6 | 36.8 | −9.2 |
| 1983 | 6.1 | 34.9 | −28.8 |
| 1984 | 11.6 | 37.1 | −25.5 |
| 1985 | 4.1 | 36.7 | −32.6 |

Source: Inter-American Development Bank, "Economic and Social Progress in Latin America, 1986 Report" (Washington, D.C.: IDB, 1986), table III-8, p. 35.

## TABLE 2.—ECONOMIC INDICATORS OF THE DEBTOR COUNTRIES, 1981–86

[Annual percent change unless otherwise indicated]

| Indicator | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 [1] |
|---|---|---|---|---|---|---|
| Countries with debt-serving problems: | | | | | | |
| Per capita real GDP | −1.0 | −2.5 | −4.8 | 0.2 | 0.6 | −0.5 |
| Trade balance (billions of dollars) | −19.4 | −6.0 | 22.0 | 34.6 | 35.4 | 24.2 |
| Terms of trade [2] | −2.8 | −4.8 | −2.8 | 2.7 | −2.5 | −5.8 |
| Export volume | −3.0 | −4.2 | 5.4 | 7.0 | 1.4 | 0.6 |
| Debt-export ratio (percent) | 180.2 | 234.5 | 252.3 | 244.2 | 260.6 | 275.4 |
| Western hemisphere: | | | | | | |
| Per capita real GDP | −1.2 | −3.2 | −5.3 | 0.8 | 1.7 | −0.6 |
| Trade balance (billion of dollars) | −3.2 | 7.2 | 28.7 | 37.0 | 33.6 | 26.9 |
| Terms of trade [2] | −4.4 | −5.8 | −2.8 | 4.0 | −3.0 | −5.1 |
| Export volume | 6.1 | −2.2 | 7.1 | 7.3 | −1.2 | −0.2 |
| Debt-export ratio (percent) | 208.8 | 267.2 | 287.5 | 273.3 | 295.0 | 311.1 |
| Sub-Saharan Africa: | | | | | | |
| Per capital real GDP | −1.2 | −2.8 | −2.8 | −1.4 | −0.9 | −2.4 |
| Trade balance (billions of dollars) | −4.5 | −3.9 | −1.6 | 0.6 | 0.1 | −0.7 |
| Terms of trade [2] | −7.3 | −6.5 | 1.2 | 5.0 | −2.0 | −1.9 |
| Export volume | −2.6 | 4.4 | 0.4 | 4.9 | 0.7 | 9.1 |
| Debt-export ratio (percent) | 169.3 | 201.3 | 215.8 | 216.3 | 240.3 | 236.0 |

[1] Preliminary.

[2] Terms of trade measure the price of exports relative to the price of imports.

Source: International Monetary Fund, "World Economic Outlook" (IMF, April 1986).

The optimism was shattered in 1985. The news from the countries of the Organization for Economic Cooperation and Development was adequate: continued industrial country growth, a fall in the U.S. dollar, and a drop in interest rates. Nevertheless, the debtor countries experienced a fall in their dollar export prices, a sharp deceleration in the growth of export volumes, and therefore a drop in dollar export earnings for the year. Coming against a backdrop of acceptable OECD economic performance, and after several years of debtor country austerity, that outcome was highly unsettling. Although, according to the table, per capita output in Latin America grew slightly, the aggregate figure is deceptive. Output in Brazil, the largest of the major debtor countries, grew rapidly, while real per capita GDP growth was negative on average for the other major debtors of Latin America.

For the first time since the onset of the crisis, the poor performance of the debtor countries in 1985 could not be blamed on either external conditions or internal profligacy. Commercial banks further restricted their exposure to the indebted countries of Latin

America and Africa during the year, as can be seen in Table 3 (from mid-1985 to March 1986, exposure for the nine major U.S. banks fell by $1.6 billion in Latin America). So far, 1986 has been even worse for most of the heavily indebted countries in Latin America and Africa. Real commodities prices have continued to fall, bank lending has been stagnant, and the forecast is for negative per capita growth for much of Latin America and Africa for 1986 and 1987.

TABLE 3.—EXPOSURE OF 9 MAJOR U.S. BANKS IN THE DEBTOR COUNTRIES, VARIOUS PERIODS, 1982–86 [1]

[Billions of dollars unless otherwise specified]

| Region | End-1982 | Mid-1984 | March 1986 |
|---|---|---|---|
| Total exposure: | | | |
| All LDCs | 83.4 | 84.0 | 75.6 |
| Latin America | 51.2 | 53.8 | 52.2 |
| Africa | 5.6 | 4.9 | 3.6 |
| Exposure as percent of bank capital: | | | |
| All LDCs | 287.7 | 246.3 | 173.3 |
| Latin America | 176.5 | 157.8 | 119.6 |
| Africa | 19.3 | 14.3 | 8.1 |

[1] Exposures are total amounts owed to U.S. banks after adjustments for guarantees and external borrowing. Total exposures are calculated for all LDC's (OPEC. Nonoil Latin America, Nonoil Asia, Nonoil Africa); Latin America (Nonoil Latin America plus Ecuador and Venezuela); and Africa (Nonoil Africa plus Algeria, Gabon, Libya, and Nigeria).

Source: Federal Financial Institutions Examination Council, "Country Exposure Lending Survey." Mid-1984 data from statistical release of October 15, 1984; March 1986 data from release of August 1, 1986.

In October 1985, in reaction to the unfavorable events of that year, U.S. Secretary of Treasury James A. Baker III offered a plan that acknowledged that the debtor countries were not rebounding from the crisis of the early 1980's as had been forecast. But the methods of the Baker plan were merely an intensification of earlier procedures. Under the plan, the commercial banks were encouraged to make new loans to the heavily indebted countries, specifically $20 billion of increased exposure over three years, while the multilateral lending institutions were called upon to make $9 billion of new loans in return for policy adjustments in the debtor countries. The debtor countries were expected to continued to meet huge interest obligations on a timely basis. Latin American debtors, for example, have obligations projected at $94.6 billion for 1986–88.[4] The Baker plan was significant not as a new policy departure, but rather as an admission by the United States that the debt strategy up to 1985 had not generated adequate economic growth in the debtor economies.

While the creditors have ridden waves of optimism and pessimism in the past five years, many observers and policymakers in the debtor countries have seen the story more simply as one of fairly continuous decline. With the exception of a mediocre year in 1984, they have had little to cheer about. Critics of the creditor governments' current approach argue that the failure of the debtor countries to prosper is not surprising in view of the collapse of investments there and in view of the political and economic uncertanities that result from the heavy external debt burden. They point out that among the countries that have been forced to reschedule their debts in the past decade, there are almost no success stories of countries that have pursued IMF austerity measures and World Bank structural adjustments to reestablish creditworthiness and restore economic growth. As Table 4 shows, all but one of the countries that rescheduled their bank debts between 1978 and 1981, before the onset of the global debt crisis, have languished with slow growth and without access to the international capital markets. The only notable case of success is Turkey, whose turnaround after a debt crisis in the late 1970's was, as I argue later, materially assisted by an inflow of some $5 billion in new official loans during 1978–82—far more than anything available today.[5]

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[4] The forecast is by Data Resources, Inc. (DRI), in the Latin American Review (Lexington, Mass.: DRI summer 1986), table 3, p. 6.

TABLE 4.—DEBT RESCHEDULINGS AND ECONOMIC INDICATORS, 1978–86

| First rescheduling | Percent change in per capita real GDP between first rescheduling and 1985 | Later rescheduling | Access to capital markets in 1986 |
|---|---|---|---|
| 1978: | | | |
| Peru | −13.0 | 1980, 1983, 1984 | No. |
| Jamaica | −14.3 | 1981, 1984, 1985 | No |
| 1979: Turkey | 9.4 | 1981, 1982 | Yes. |
| 1980: | | | |
| Togo | [1] −21.0 | 1983 | No. |
| Zaire | [2] −5.8 | 1983, 1984, 1985 | No. |
| Bolivia | −28.2 | 1981 | No. |
| Nicaragua | −13.1 | 1981, 1982, 1984 | No. |
| 1981: | | | |
| Madagascar | n.a. | 1982, 1983, 1984 | No. |
| Sudan | n.a. | 1982, 1983, 1984, 1985 | No. |

[1] Until 1983.
[2] Until 1984.
n.a. Not available.

Sources: Per capita real GDP from IMF, "International Financial Statistics," various issues, and unpublished IMF data. Rescheduling dates from Maxwell Watson and others, "International Capital Markets: Developments and Prospects," Occasional Paper 43 (IMF, February 1986).

Dissatisfaction among creditor nations with the current debt arrangements has grown sharply in the past year. Peru has made a break with the system by declaring unilaterially its intention to limit debt servicing to 10 percent of exports. Powerful opposition groups within Argentina, Bolivia, Brazil, Mexico, and many other countries are pressing for similar policy initiatives from their governments. In response, Senator Bill Bradley of New Jersey has broken new political ground by offering a plan for managing the debt crisis that is based on debt forgiveness by the commercial banks rather than debt rescheduling and full interest servicing. The Bradley plan would maintain the current case-by-case approach, conditioning debt relief on economic policy reforms. The exact nature of relief would be subject to negotiation, but an example might be a yearly package of 3 percentage points of interest rate relief, 3 percent forgiveness of principal, and $3 billion in new loans from the multilateral lenders.[6]

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[5] Recently, Brazil, the black sheep of 1984, has been touted as the great success story of 1986, in view of its rapid economic growth for the past two years. But Brazil is an example of a country that has explicitly rejected participation in standard IMF programs. Its current growth is fueled by large budget deficits, a rapidly growing internal debt, a huge black market premium on the exchange rate, and price controls, as well as favorable external conditions, such as falling interest rates and a terms of trade improvement. Thus, the sustainability of Brazil's miniboom is open to doubt, and the "lessons" of Brazil for the current debt management strategy are hard to see.

In view of the problems attendant upon the current debt strategy, I propose six principles as part of a new approach to be put in its place:

—debt relief should play a role in a new comprehensive strategy of debt management;

—debt relief can and must be applied selectively, limiting relief to the countries most in need;

—selective debt relief would not threaten the international financial system, since the bank debt of most countries is far too small to pose any systematic risk, while many of the largest debtors, such as Brazil and South Korea, do not need, and probably would not seek, debt relief;

—even where debt relief is not a desirable option, other financial arrangements can and should be found to increase the net transfer of resources to the debtor countries;

—many of the current risks to the debtor countries should be shifted back to the world financial markets by encouraging multiyear rescheduling agreements, explicit interest capitalization, and contingency clauses linking capital flows to the terms of trade;

—as in the current arrangements, the financial restructurings should be carried out on a case-by-case basis, in conjunction with internationally supervised programs of policy reform in the debtor countries.

Debt relief is necessary as a safety value for countries that are collapsing under the debt burden. It makes little sense to argue that relief is unwise because "on average" the debtor countries may be recovering or because the largest debtors might not need relief. There are dozens of countries struggling now under the debt burden, and some are not making it. Peru is a case in point. The Peruvian economy is in a deep depression, and its terms of trade, already falling, are projected to plummet 14 percent in 1986. Per capita gross domestic product has declined by about 15 percent since 1980, and real wages have declined by an estimated 40 percent. The social fabric is crumbling. Murder and terrorism are the daily fare of Lima. President Garcia's announcement last year of a unilateral suspension of debt repayments was a true cri du coeur.

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[6] Senator Bradley's proposal is notable both for shifting the political debate in the United States (Bradley is the first major U.S. politician to endorse a program of relief) and for linking debt negotiations with trade talks. There have been several earlier proposals for relief, following the pioneering proposal in 1983 of Prof. Peter Kenen for a new public institution to repurchase LDC debt at a discount from the commercial banks. See Peter B. Kenen, "A Bailout Plan for the Bank," New York Times, Mar. 6, 1983. For Senataor Bradley's plan, see "A Proposal for Third World Debt Management," presented at the Congressional Summit on Exchange Rates, Zurich, Switzerland, June 29, 1986.

The response from the creditors has been to prove that he cannot get away with it.

For countries, such as Peru, that have suffered very large drops in living standards, out-and-out debt relief is now warranted. As a modification to Senator Bradley's proposal, which seems to make debt relief available to all debtors, I develop a proposal in which objective indicators, such as a country's decline in real per capita output over a period of several years, are used to trigger debt relief on a selective basis. Selectivity is important both to protect the financial system and to reduce the moral hazards that would be present with the unconditional availability of debt relief.

For countries that are performing poorly, but not so poorly as to require debt relief, the debt servicing burden should be eased by methods that compromise between rescheduling and forgiveness. One realistic possibility is to move away from the current system, in which only the existing creditors are called upon to make new loans, towards a system in which new lenders are also enabled to enter, by granting their claims seniority relative to the existing creditors. International agreements could be reached to provide that the new loans will be serviced in entirety before any of the existing debt is serviced. In some cases such agreements would require a rewriting of existing loan covenants. An attraction of such an approach it that it would promote a capital inflow into the country without necessitating a definitive decision on the need for debt forgiveness. The current bank creditors would be fully repaid only if the debtor country in fact grows fast enough to service both the new debt, which has priority, and the old. Otherwise, some part of the debts of the existing creditors will have to be forgiven at some point. Other mechanisms for promoting new investments should also be introduced. Both swaps of debt for equity and rescheduling arrangements that are contingent on the debtor country's terms of trade, as in the recent agreement with Mexico, are now being tentatively tried, but should be greatly expanded in coverage. As in most debt workouts, the ultimate solutions will surely be messy and filled with "ad hockery." It is clear, however, that bolder approaches are now needed.

## STRATEGY IN THE DEBT CRISIS

Although it is sometimes asserted that official creditors and bank creditors have been treated equally in the management of the debt crisis, in the past five years the commercial banks have received large net transfers from the debtor countries, while the official creditors, including the creditor governments and the multilateral institutions, have made large net transfers to the debtor countries. Operationally, it can be argued that the official creditors are indeed "bailing out the banks."

As can be seen from Table 5, large positive net transfers of resources from the private creditors (mostly banks) to the major borrowing countries came to a quick halt during 1982; the transfers turned negative during 1983, significantly negative during 1984. At the same time, resource transfers from the official creditors have continued to be positive, though not as large as the net transfers to the private creditors. Even in Sub-Saharan Africa in 1984, negative transfers to private creditors were larger than positive net transfers from official sources. While comprehensive World Bank data for 1985 are not yet available, there is little doubt that the diverging trend between private and official creditors widened substantially. One of the important reasons for the differing pattern of resource transfers is that the official creditors have rescheduled interest payments through the Paris Club, the international forum for rescheduling service on debt granted by official bilateral creditors, while of course the commercial banks have not.

TABLE 5.—NET RESOURCE TRANSFERS TO DEBTOR COUNTRIES, 1981–84

[[In billions of dollars]

| Category | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|
| Major debtor countries: | | | | |
| Official creditors | 5.7 | 5.4 | 1.5 | 4.6 |
| Private creditors | 4.8 | 1.0 | −1.8 | −10.0 |
| Latin America: | | | | |
| Official creditors | 2.6 | 3.0 | 1.8 | 3.2 |
| Private creditors | 4.0 | 0.4 | −3.5 | −10.9 |
| Sub-Saharan Africa: | | | | |
| Official creditors | 3.3 | 3.2 | 3.3 | 2.0 |
| Private creditors | 1.7 | 2.6 | 1.8 | −2.1 |

Source: World Bank "World Debt Tables: External Debt of Developing countries," 1985–86 ed. (World Bank, 1986). For World Bank country classifications, see pp. xiii–xlv.

Creditor government policies have further supported the commercial banks through their decisions in the area of bank supervision. The most important decision in this area has been that of the U.S. banking regulators to allow the commercial banks to hold almost all of their LDC debt on their books at face value, and to count each dollar of interest receipts as a dollar of income, despite the fact that a large part of the interst receipts is made possible through fresh, "involuntary" lending by the same banks (involuntary in the sense that each individual bank is forced to increase exposure on a pro rata basis).

The creditor strategy has successfully avoided an international banking crisis. The commercial banks have not only continued to receive interest servicing from most of the debtor countries, but enjoyed large net resource transfers during 1984 and 1985. It appears that the banks have been able to reduce their absolute exposure levels in the debtor countries mainly by calling in their claims on private-sector debtors at a greater rate than they have made concerted loans to the governments. For example, between mid-1984 and March 1986, bank loans in Latin America to nonbank official entities rose by $4.5 billion, while loans to banks and private nonbank borrowers fell by $6.1 billion.[7]

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[7] The data from the Federal Financial Institutions Examination Council, "Country Exposure Lending Survey: Oct. 15, 1984, and Aug. 1, 1986," table II, which divides the debtors by category: banks, public borrowers, and private nonbank borrowers There are, unfortunately, several problems with interpreting the data on falling exposures and on the shifts between public- and private-sector debtors. First, a small and undisclosed part of the decline in exposure is due to write-offs of debt rather than amortizations of debt. Second, part of the shift to public-sector borrowers reflects not new concerted lending, but rather an ex post shift of existing debt from the private sector to the public sector through a variety of schemes in which private-sector debt has been absorbed by governments. The most important interpretation of the data, however, is prob-

Continued

One of the deep ironies of the current situation is that while the creditor strategy is applied to all debtor countries, the banking risks result from only a few countries and apply to only a few banks, as evidenced in Table 6. While the nine major banks in the United States do have about 100 percent of capital locked up in Argentina, Brazil, Mexico, and Venzuela, the exposure of other U.S. banks to these countries represents only 35 percent of capital. For Latin America as a whole, bank exposure is 120 percent of capital for major U.S. banks, but only 43 percent of capital for other banks. Indeed *all* LDC debt is only 61 percent of bank capital for the others.

Table 6 puts to rest the myth that the U.S. banks could not afford to grant widespread debt relief. With just a modicum of selectivity, debt relief could be easily absorbed by the banks. Suppose, for example, that debt relief comes in the form of five years of zero interest payments, with the missed payments forgiven rather than capitalized. assuming a market interest rate of 7 percent during the five-year interval, such relief has a present value of $0.31 per dollar of debt.[8] Suppose further that such relief is granted to all but the three largest debtors—Brazil, Mexico, and Venezuela—of the individual countries in a crisis shown in Table 6. The cost of such relief would be only 15 percent of bank capital for the major U.S. banks and 5 percent of bank capital for all other U.S. banks. If the relief were also extended to include Brazil, Mexico, and Venezuela, the cost would rise to 41 percent of bank capital for the major banks and 14 percent for the rest. Later in the paper I suggest a criterion for granting relief that further reduces the costs.

TABLE 6.—EXPOSURE OF U.S. BANKS TO THE DEBTOR COUNTRIES, MARCH 1986 [1]

| Region and country | Nine major banks | | | All other banks | | |
|---|---|---|---|---|---|---|
| | Billions of dollars | Percent of capital | Percent of loans to LDC's | Billions of dollars | Percent of capital | Percent of loans to LDC's |
| All LDCs | 75.6 | 173.3 | 100.0 | 40.3 | 61.0 | 100.0 |
| Latin America | 52.2 | 119.6 | 69.0 | 28.4 | 43.0 | 70.5 |
| Africa | 3.6 | 8.1 | 4.8 | 1.0 | 1.7 | 2.5 |
| Brazil | 16.0 | 36.7 | 21.2 | 7.7 | 11.6 | 19.1 |
| Mexico | 13.8 | 31.6 | 18.3 | 10.4 | 15.8 | 25.8 |
| Venezuela | 6.9 | 15.8 | 9.1 | 2.8 | 4.2 | 8.4 |
| Argentina | 6.0 | 13.9 | 7.9 | 2.5 | 3.7 | 6.2 |
| Chile | 4.0 | 9.1 | 5.3 | 2.3 | 3.5 | 5.7 |
| Philippines | 3.6 | 8.3 | 4.8 | 1.4 | 2.1 | 3.5 |
| Yugoslavia | 1.3 | 3.0 | 1.7 | .7 | 1.1 | 1.7 |
| Ecuador | 1.2 | 2.8 | 1.6 | .8 | 1.1 | 2.0 |
| Peru | .8 | 1.8 | 1.1 | .6 | .9 | 1.5 |
| Uruguay | .7 | 1.6 | .9 | .2 | .3 | .5 |
| Panama | .7 | 1.6 | .9 | .3 | .5 | .7 |
| Nigeria | .6 | 1.5 | .8 | .2 | .3 | .5 |
| Morocco | .6 | 1.4 | .8 | .2 | .3 | .5 |
| Ivory Coast | .3 | .7 | .4 | .1 | .2 | .2 |
| Dominican Republic | .3 | .7 | .4 | .1 | .2 | .2 |
| Costa Rica | .2 | .5 | .3 | .2 | .3 | .5 |
| Jamaica | .1 | .3 | .1 | 0 | 0 | 0 |

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ably the one offered in the text: concerted lending has covered public-sector debt only, so that the private sector has been forced to amortize loans without any way to obtain new lending.

[8] Calculated as $0.07+0.07(1.07)+0.07(1.07)^2+0.07(1.07)^3+0.07(1.07)^4=0.31$.

TABLE 6.—EXPOSURE OF U.S. BANKS TO THE DEBTOR COUNTRIES, MARCH 1986 [1]—Continued

| Region and country | Nine major banks | | | All other banks | | |
|---|---|---|---|---|---|---|
| | Billions of dollars | Percent of capital | Percent of loans to LDC's | Billions of dollars | Percent of capital | Percent of loans to LDC's |
| Romania | .1 | .3 | .1 | 0 | .1 | 0 |
| Zambia | .1 | .2 | .1 | 0 | 0 | 0 |
| Honduras | .1 | .1 | .1 | 0 | .1 | 0 |
| Malawi | .1 | .1 | .1 | 0 | 0 | 0 |
| Liberia | .1 | .1 | .1 | 0 | 0 | 0 |
| Senegal | .1 | .1 | .1 | 0 | 0 | 0 |
| Nicaragua | 0 | .1 | .1 | 0 | .1 | 0 |
| Sudan | 0 | .1 | 0 | 0 | 0 | 0 |
| Zaire | 0 | 0 | 0 | 0 | 0 | 0 |

[1] Exposures are total amounts owed to U.S. banks after adjustments for guarantees and external borrowings. Total exposures are calculated for all LDC's (OPEC, Nonoil Latin America, Nonoil Asia, Nonoil Africa); Latin America (Nonoil Latin America plus Ecuador and Venezuela); and Africa (Nonoil Africa plus Algeria, Gabon, Libya, and Nigeria). The list of individual countries is not all-inclusive and therefore does not sum to the total for all LDC's. Figures are rounded.

Source: Federal Financial Institutions Examination Council, "Country Exposure Lending Survey: August 1, 1986."

## WHY THE DEBTORS DO NOT REPUDIATE

The creditor strategy has so far been notably less successful for the debtor countries than it has been for the banks. Real living standards in the debtor countries have declined sharply since the early 1980's in many countries, and further declines are in prospect for 1986. Table 7 shows the declines in per capita real GDP for the debtor countries in Latin America since 1981. Unfortunately, as striking as these declines are, they have not contributed much towards the goal of improved creditworthiness, since, as shown in Table 8, debt-export ratios throughout Latin America are, with the exception of Brazil, higher in 1985 than they were in 1982. The GDP declines, furthermore, understate the overall declines in living standards in most countries, since in addition to falling output per capita most of these economies have also suffered significant declines in their terms of trade. In most of the debtor countries, real wages have plummeted. In Peru, for example, real wages in 1985 were 49 percent of their level a decade before; in Uruguay, 64 percent; and in Mexico, 74 percent.[9]

TABLE 7.—*Changes in per capita real GDP, Latin America, 1981–85*

[In percent]

| *Country* | *Cumulative change* |
|---|---|
| Argentina | −18.5 |
| Bolivia | −28.4 |
| Brazil | −2.0 |
| Chile | −8.7 |
| Colombia | −0.1 |
| Costa Rica | −11.2 |
| Ecuador | −3.9 |
| El Salvador | −24.0 |
| Guatemala | −18.3 |
| Jamaica | [1] −2.2 |
| Mexico | −4.3 |
| Panama | 0.7 |

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[9] See United Nations, Economic Commission for Latin America and the Caribbean, "The Economic Crisis: Policies for Adjustment, Stabilization, and Growth" (Mexico City: April 1986), table 16, p. 108.

**Table 7**.—*Changes in per capita real GDP, Latin America, 1981-85*—Continued

[In percent]

| *Country* | *Cumulative change* |
|---|---|
| Peru | −14.8 |
| Uruguay | −18.6 |
| Venezuela | −21.6 |

[1] To 1984.

Source: United Nations Economic Commission for Latin America and the Caribbean, "The Economic Crisis: Policies for Adjustment, Stabilization, and Growth" (Mexico City: April 1986).

TABLE 8.—DEBT-EXPORT RATIOS, LATIN AMERICA, 1981-85

[Percent]

| Country | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|
| Argentina | 333.4 | 447.3 | 458.6 | 489.7 | 509.0 |
| Brazil | 277.5 | 356.8 | 376.7 | 330.8 | 348.6 |
| Chile | 276.8 | 332.8 | 361.2 | 399.7 | 414.5 |
| Colombia | 150.1 | 183.0 | 243.1 | 248.2 | 245.9 |
| Ecuador | 198.2 | 232.7 | 259.5 | 243.4 | 254.1 |
| Mexico | 243.3 | 304.1 | 323.6 | 291.5 | 326.9 |
| Peru | 229.4 | 270.9 | 323.8 | 335.0 | 368.1 |
| Venezuela | 118.4 | 154.5 | 197.9 | 171.7 | 181.2 |

Source: Data Resources, Inc., "Latin American Review" (Lexington, Mass: DRI, Summer 1986).

Why, then, have the debtor countries continued to pay their debts? In the 1930's, in a similar economic situation, almost every Latin American government unilaterally suspended servicing on its external bond obligations. So far, only Peru has broken ranks and unilaterally reduced debt payments. Some other countries have fallen into deep arrears, but have continued to bargain with the commercial banks on the basis of a resumption of interest servicing. Most countries have in fact continued to make their interest payments.

The major difference between the 1930's and the 1980's appears to lie in the absence of a "hegemonic" power in the 1930's, a role that the United States fills in the 1980's. As Charles Kindleberger has amply documented, none of the creditor governments in the 1930's was willing or able to provide the public goods needed to perserve the economic order.[10] Without a lender of last resort and an enforcer of international contractual obligations, the debtor countries chose to default and generally faced only mild sanctions in response. Only in rare cases did creditor governments force debtor countries to continue to service their debts.

In the 1980's, the United States has managed the debt crisis with a view toward maintaining continued commercial bank debt servicing. Under the U.S. aegis, the other creditor governments and, through them, the multilateral institutions have supported that basic strategy. The ability of the banks to enforce their loan agreements has rested not only on their own bargaining power, but also, crucially, on the willingness of the U.S. government to back them up at critical junctures. With the creditor governments placing so much emphasis on continued servicing of bank debts, a decision by a country unilaterally to suspend its debt repayments is as much a foreign policy decision as a financial one.

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[10] C.P. Kindleberger, "The World in Depression, 1929-39" (University of California Press, 1986).

Countries that might happily break with the commercial banks are loath to break with the rest of the international system. Retaliation by the banks would involve no more than a cutoff of new loans, a withdrawal of trade credits, and possible seizure of some assets of the debtor government held in the creditor countries. But breaking official ties with creditor governments would involve such crucial financial and nonfinancial areas as aid, trade policy, technology licensing, and arms deals. Moreover, as Carlos Diaz-Alejandro pointed out, defaults could let loose political passions that would threaten the debtor government itself: "For a while, the leader may bask in nationalist glory, but the forces unleashed by default, especially an active one, may threaten constitutional order and could reopen the gates to populist-nationalistic authoritarian generals—after all, the nation would be surrounded by enemies."[11]

The creditor governments have also been reinforced by the international financial and development institutions. The IMF routinely requires that countries come to terms with their creditor banks as a condition for an IMF program. In most cases an agreement in principle between the debtor and the banks is a precondition for an IMF loan; in others the IMF program is approved on the basis of a likely agreement and may be suspended if agreement is not reached. While the IMF generally does not specify the terms that an agreement must follow, the commercial banks know that they can afford to hold out for full interest servicing, with a rescheduling of principal.

Without an IMF program, the country typically cannot reschedule its debts with official export credit agencies of the creditor governments in the Paris Club. Failure to reschedule debts with foreign governments can trigger cutoffs of foreign aid and export credits from industrial country governments. Such credits are not only an important form of finance, but are often necessary for attracting foreign direct investment by foreign multinational firms.

Failure to reach an agreement with the Fund can also jeopardize new lending from the World Bank and the multilateral development banks. In some cases, such as with many World Bank structural adjustment loans, World Bank conditionality has de facto required that the country be in compliance with an IMF program. World Bank programs are also often delayed until countries come into compliance with the Fund. In any event, a country that rejects an IMF program does so at considerable risk to most of its other channels of official financial support.

What this analysis suggests is that the creditor governments could significantly alter the balance of power between the private banks and the debtor countries if they desired to do so. The most important change would be the easiest: the creditor governments and the multilateral institutions would simply have to declare that official policies, such as foreign aid and IMF programs, would not be conditioned on the success or failure of negotiations between the debtor country and the banks. Even without more explicit instruments of persuasion or a legal requirement on the banks, such a shift in policy would probably be sufficient to lead to considerably easier terms on bank debt servicing. A hands-off policy by the official creditors was precisely the U.S. government policy toward Latin American debtor governments that were in default on the outstanding international bond obligations during the 1940's. The policy was likely important in inducing the Foreign Bondholders Protective Council, which negotiated with the debtor governments, to reach postwar settlements involving, in many cases, a significant amount of relief.

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[11] Diaz-Alejandro, "The Latin American Debt Crisis," p. 381.

Depending on the nature of debt relief that is sought by official creditors, such a laissez-faire policy might not be enought to impel the banks to go along. In that event, some combination of regulatory action or even legislation might be necessary to induce the banks to join official creditors in granting debt relief. In the end, though, the U.S., European, and Japanese governments would have several policy instruments at their disposal if they chose to deploy them. The power of the U.S. government to induce both U.S. and foreign banks to grant debt relief was evident in the case of the Chrysler Corporation bailout, when the government successfully pressured the banks to convert some of their debt instruments into Chrysler equity. As chroniclers of the negotiations among Chrysler, the banks, and the U.S. Treasury have observed, "Looming over the bickering and squabbling between the lenders was the indubitable presence of the U.S. government. Both the American and the foreign lenders conducted their business at the mercy of Congress, the Federal Reserve Board and other federal agencies. Every facet of banking—from electronic cash dispensers to new bank branches—was monitored, directly or indirectly, by the same politicians who had granted aid to Chrysler [and who were not pressing for relief from Chrysler's bank creditors]." [12]

## THE ECONOMICS OF CRISIS ADJUSTMENT

When economists consider the burden of the foreign debt, they usually think of the cost to the debtor country of making a transfer to the rest of the world. The debt burden is measured simply as the discounted flow of resources that the debtor country must provide to its creditors. But over and above the transfer burden is the enormous deadweight loss resulting from the way that the current debt overhang discourages investment in the debtor countries.

Were the debt burden limited to the direct costs of making transfers abroad, the debt crisis would be painful but not as debilitating as it has been for most debtor countries. For the typical Latin American debtor country, external debt as a percentage of GNP now averages about 60 percent. Suppose that in a normal period the country has a trend growth rate of 4 percent per annum and faces a real interest rate, including fees and spreads, of 8 percent. If the country must service enough debt each year to keep the debt-GNP ratio constant, it must make net transfers abroad equal to the debt-GNP ratio multiplied by the difference between the interest rate and the growth rate. In other words, the debt-GNP ratio would be stabilized with annual net international transfers equal to

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[12] Michael Moritz and Barret Seaman, "*Going for Broke: The Chrysler Story*" (Doubleday & Co., 1981), p. 310.

0.60 (0.08—0.04), or 2.4 percent of GNP. An annual trade surplus of 2.4 percent of GNP seems a reasonably attainable goal. If the creditors are more restrictive and insist not that the debt-GNP ratio be stabilized but that the absolute value of the debt be stabilized, then the net transfers abroad would have to equal the annual burden, which is 4.8 percent of GNP, a much larger but also attainable goal.

How painful would it be for a country to generate a trade surplus of either 2.4 percent or 4.8 percent of GNP? On the eve of the debt crisis, most of the Latin American debtors were near to trade balance, although current accounts were in large deficit since net interest payments abroad were already significant. Thus, the trade surplus would have had to rise by, say, 2 to 5 percent of GNP. The ease of accomplishing that shift is determined in part by the ease with which domestic resources can be reoriented from domestic production to net exports or from nontradables sectors to tradables sectors.

Suppose as the simplest case that nontradables can be converted into tradables at a constant marginal rate of substitution that is equal to the ratio of prices of two sectors at an initial base period. Measured in base period prices, each unit value reduction of nontradables output generates a unit value increase of tradables output. In this case, the requisite trade surpluses can be achieved by simply forgoing a couple of years of real consumption growth while the economy continues to grow along its initial growth path. For example, an economy begins with trade balance, with consumption, investment, exports, and imports all initially growing at 4 percent a year, with consumption constituting 75 percent of GDP. As consumption is cut back, all released resources move one for one into increased net exports, with all values measured at base period prices. After a year of unchanged consumption, the national saving rate would have grown by about 2.8 percentage points of GDP. In about 1.7 years, the national saving rate would have grown by the requisite 4.8 percentage points. Of course, with population growth, unchanged aggregate consumption means falling per capita consumption. With 2 percent population growth, per capita consumption would fall by 2 percent for 1.7 years, rather than rising by 2 percent a year as would be typical along the stable growth path.

For some debtor countries, such as South Korea, the adjustment went almost this smoothly. Korea never lost the confidence of its international creditors, so it was not forced into an emergency rescheduling, although it did receive clear signals in the early 1980's to reduce its pace of debt accumulation. Korean total real consumption, both public and private, grew very slowly during 1979-82, only 2.2 percent per annum, compared with 12.5 percent per annum during 1975-79. The trade deficit was reduced by 4.5 percentage points of GNP from 1979 to 1983. Korea suffered only one year of negative growth, 1980, and was able to restore rapid growth by 1983. In 1986, the economy is expected to grow by 10 percent.

For most of the debtor countries, the adjustment has been far more painful. Indeed, per capita consumption has declinced by far more than would theoretically be necessary, at the same time that growth has collapsed and debt-GNP and debt-export ratios have continued to rise. What is it that has prevented the smoother adjustments achieved by Korea? One difficulty is that the reduction in domestic spending has not been converted one for one into higher net exports, so that real GNP has declined as the nontraded goods sector has shrunk. Even to the extent that resources have remained fully employed, the cost of producing increasing amounts of tradables in terms of forgone production of nontradables has proved to be steeply increasing in most of the debtor countries, since highly protected inefficient industries in Latin America and Africa could not easily be reoriented into producing competitive exports. Also, as the nontraded goods sector has collapsed, there has been a massive increase in unemployed resources, which failed to find their way into tradables production. Furthermore, increases in volume of traditional commodity exports have been blunted by the continuing fall in commodities prices, so that commodity export earnings have been stagnant at best.

The failure of Latin America and Africa to increase export earnings should be regarded in part as the legacy of their inadequate trade policies in previous decades. A diversified export base was never established because of inward-looking, protectionist trade policies and overvalued exchange rates. Not only did these trade policies contribute to the onset of the crisis; they have made it harder to react flexibly in response.[13]

A second key difference between Korea's smooth adjustment and the experience of most of the debtor countries is that the drop in spending has fallen heavily on investment as well as consumption, with highly deleterious effects on growth in the medium run. One explanation is that the credit crunch hit the Latin American debtors directly in the public sector budget. Whereas in Korea much of the debt was held directly by the private sector, it was held by the public sector in Latin America, as a result of high budget deficits in the years preceding the debt crisis. When the credit squeeze came in 1982, the Latin American countries responded by cutting public investment and, in many cases, increasing money financing of the budget, often with serious inflationary consequences. The sharp contraction in government spending sent the Latin American countries into a deep recession in 1983. During the next two years, the Latin American countries groped with decreasing real tax revenues (due both to inflation and to recession), rising inflation, and the need to cut spending even further. Most important, because of the large overhang of debt, the Latin American governments did not have the creditworthiness even to borrow in their own capital markets, so that budget deficits could not serve as an automatic stabilizer. The choice for these countries was therefore whether to reduce spending in the midst of recession or to print money. Most countries chose some combination of the two approaches.

The debt overhang now discourages investments by the public sector even beyond its direct budgetary burden. A fragile government riding the storm of a downward spiral of living standards cannot shift spending from current consumption to investment without justifying the shift politically on the grounds that the citizens in the country will soon be much better off by virtue of the investment. But the citizenry of the debtor countries now believes that a shift from consumption to investment will serve first, and perhaps only, to improve the capability of the country to service its debts. Unless an increase in investment spending is combined with substantial debt relief, the needed squeeze on consumption is seen as something that is done for Citibank rather than for the nation itself.

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[13] Brazil is a partial exception in Latin America. For a discussion of Latin American trade policies and their implications for the debt crisis, see Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia."

The overhang of the debt also encourages capital flight, which further depresses investment, the startling decline of which is shown in Table 9. Since the private sector well understands that the public sector is starved for funds, no astute wealthholder now leaves any signs of wealth lying around to advertise a ready source of revenues for the fiscal authorities. Wealthholders hold their assets outside of the country to avoid taxation, with the result that new private savings simply spill over into capital flight, rather than into real investment. Capital flight is now a symptom of the debt overhang, and not a cause, as it was initially thought when it reflected the conversion of domestic financial assets into foreign financial assets in anticipation of devaluations of overvalued currencies.

TABLE 9.—RATIOS OF GROSS INVESTMENT TO GDP, DEBTOR NATIONS, VARIOUS YEARS, 1980–85

[In percent]

| Category | 1980 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| Countries with debt servicing problems | 25.4 | 19.1 | 18.0 | 18.0 |
| Countries without debt servicing problems | 28.1 | 26.5 | 26.4 | 26.6 |
| Western hemisphere | 23.4 | 17.4 | 17.2 | 17.9 |
| Sub-Saharan Africa | 19.9 | 17.7 | 16.5 | 17.2 |

Source: IMF, "World Economic Outlook" (April 1986), table A7, p. 186.

Private investment has been impeded even in the export sectors, which depend on foreign demand rather than domestic demand and which have gained substantially in profitability because of real exchange rate depreciations since 1982. Private-sector entrepreneurs do not feel safe leaving their money in the country, even in a temporarily profitable sector, if it appears that the rest of the economy, and perhaps the government itself, is collapsing. The investments are vulnerable not only to tax increases, but also to the possibility that the government will, at some point, abandon debt servicing, repudiate the debt, and thereafter allow a sharp real appreciation of the exchange rate once again. When a stabilization effort seems to be failing, even investment in currently profitable sectors falls, since the risks of dramatic reversals in government policy are heightened. Private investment incentives are also reduced to the extent that private investments are complementary with public investments. The government must provide the roads, dams, ports, and railroads necessary to make new exports possible. All such public investments have declined sharply in recent years.

There are several more subtle ways in which the debt overhang discourages investment. Now that the ability of the debtor governments to continue to service their debts is in doubt, external private creditors have started a "grab race" to get their assets out of the country. Individually, these creditors have an incentive to call in their claims against the overextended debtor countries, even if doing so injures the economic performance of the debtor so much that the creditors suffer collectively. Preventing such a destructive race to liquidate assets is one of the major purposes of a bankruptcy code, which restricts the ability of individual creditors to act against the group interest. Unfortunately, countries cannot file for Chapter 11 protection. It has been argued that the concerted lending packages have overcome the problem, but in fact the commercial banks have been able to reduce their absolute exposures in Latin America and Africa despite the strategy of concerted lending. It appears that while exposure to debtor governments has gone up, exposure to the private sectors of these countries, which are not protected by concerted lending, has declined even more.

At present, new external lenders will not make new loans to a debtor government even for investments whose returns easily exceed the market cost of capital, since those lenders rightly fear that their claims will simply become part of the enormous pool of uncollectible claims against the debtor. Even a debtor government with a good investment project will generally not be able to attract new creditors, unless it can somehow assure them that their claims will be granted seniority relative to the existing creditors. Such assurances are not easy to structure, and they may even violate "negative pledge" clauses in the original loan agreements.

Investment rates will thus continue to be insufficient for many of the debtor countries, not because of a shortage of good investment opportunities, but rather because of the wrong financial incentives resulting from the debt overhang. Prospects for long-term growth are therefore bleak unless the incentives to make new investments can be changed.

## NEW STRATEGIES FOR RESTORING DEBTOR COUNTRY GROWTH

In the early days of the debt crisis it made sense for the creditor governments to focus their energies on protecting the commercial banks. Nobody knew in mid-1982 whether the debtor governments would in fact be able or willing to service their debts or whether the large banks might succumb to a banking run. Also, it was clear that much of the debt problem was the result of policies in the debtor countries that were in obvious need of reform. A tough approach based on continued debt servicing, concerted lending, and conditionality made sense. That case is much harder to make today. The commercial banks are clearly much stronger and would be able to absorb partial debt forgiveness. The debtors, on the other side, have now lived through several years of austerity, with little evident improvement in their creditworthiness or growth prospects.

It is not easy to predict the prospects for most of the debtor countries. On the one hand, with low investment rates and declining terms of trade, their prospects appear rather bleak. On the other hand, with declining world interest rates and a depreciating dollar that should eventually push up the dollar prices of developing country exports, the situation could brighten, even substantially. In these circumstances it is hard to be categorical, but surely the present strategy of muddling through does not protect the debtor countries against the obvious risks that they now face. At the very least, many of the risks should now be shifted from the debtor countries back to the international capital markets where they belong.

The problem of deciding what to do now about the debt crisis is that no agreed-upon standards apply. In domestic debt crises, the participants may rely on bankruptcy law to provide a framework for action. In the international context, such a framework does not exist. A simple view would hold that policymakers should therefore enforce whatever contracts have been written between the debtors and the creditor banks, regardless of the resulting duress or economic inefficiencies. But such a view flies in the face of common sense and runs counter to the basic theory of contracts itself, which has long held that contracts should sometimes not be enforced and should sometimes even be rewritten by judges. Legal theorists such as Richard Posner and Andrew Rosenfield argue that since contracts are expensive to write and therefore cannot generally include contingencies for low-probability events, it is sometimes the duty of a judge or an adjudicating party "to reduce the costs of contract negotiating by supplying contract terms that the parties would probably have adopted explicitly had they negotiated over them."[14]

This principle is applied in practice when courts impose restructurings of long-term commodity supply agreements. After a sharp rise in energy prices in the early 1970's, for example, the Aluminum Company of America (ALCOA) sought relief from a long-term contract under which it was a supplier to Essex Group, Inc. The contract had become extremely unprofitable to ALCOA and extremely favorable for the Essex Group. The court gave relief to ALCOA by imposing a "reasonable" reformation of the contract on the two parties, after they had failed to renegotiate the terms on their own. The Court described its role as follows:

> The Court's role here is limited to framing a remedy for a problem [the parties] did not foresee and provide for. And while the Court willingly concedes that the managements of ALCOA and Essex are better able to conduct their business than is the Court, *in this dispute the Court has information and hindsight far superior to that which the parties had when they made their contract.* The parties may both be better served by an informed judicial decision based upon the known circumstances than by a decision wrenched from words of the contract which were not chosen with a prevision of today's circumstances. The Court gladly concedes that the parties might today evolve a better working arrangement by negotiation than the Court can impose. But they have not done so, and a rule that the Court may not act would have the perverse effect of discouraging the parties from resolving this dispute or future disputes on their own. Only a rule which permits

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[14] Richard A. Posner and Andrew M. Rosenfield, "Impossibility and Related Doctrines in Contract Law: An Ecomomic Analysis," *Journal of Legal Studies*, vol. 6 (January 1977), 88.

> judicial action . . . will provoke a desirable practical incentive for businessmen to negotiate their own resolution to problems which arise in the life of long term contracts.[15]

In the case of the debt crisis, the question is whether to enforce a contract in which the contracting parties "did not forsee and provide for" such extremely low-probability events as all-time low commodity prices, all-time high interest rates, or the collapse of the debtor's economy.

By the standard of "contract completion," debt contracts should be forgiven in at least two circumstances: when a debtor country has suffered such a large loss of income that continued servicing of the debt poses enormous risks of economic duress or political and social instability, or when enforcement of the contract would result in such a large decline in the debtor's capacity to repay that both the creditors and debtor would be better off with a partial forgiveness of the debt. The first case is a plausible standard since the debtor would presumably have chosen to insure against repayments in such a situation. In the second case, it would be in the interests of the parties to renegotiate the contract voluntarily, Unless one of the parties believes that instead of renegotiation it can entice a third party, such as a creditor government, to bail it out.

Twenty or thirty years ago, few people would have needed convincing that it is sometimes appropriate to excuse part of all of the obligations of a debtor country. One lesson of the 1930's was that it is possible to push countries past the breaking point in attempting to collect on debts. Three major policy mistakes of the 1930's demonstrated that lesson. The first mistake was the U.S. insistence on repayments of the inter-allied war debts. The debts proved to be uncollectible in the end, but the United States pushed hard to collect them and severely weakened its allies in the process. Following a one-year repayment moratorium, President Hoover pressured France to make payments in 1932, in the depths of the Great Depression, and thereby caused the fall of the Herriot government. By 1933, U.S. pressures for repayment and the repayment themselves finally ceased, under the realities of the depression.

The second and more notorious mistake was to press for collection of the German reparations payments, even after Germany had lost access to international capital markets in the late 1920's and even after the German economy sank into deep depression. As Kindleberger puts it, "Deflation produced by the cutoff in American lending was enhanced by the brutal policies, beginning in March 1930, of Heinrich Brüning, German Prime Minister, who was determined to show the Allies that it was impossible for Germany to pay, even if he had to destroy the economy and the political system to do so." [16] He succeeded all too well, though many observers failed to recognize what was happening. Just before Germany's utter collapse came its largest trade surplus, which, as Harold Moulton and Leo Pasvolsky noted in a 1932 Brookings study, "was proclaimed by many unanalytical writers as conclusive evidence of Germany's steady progress . . . [When] it was in fact little more than a depression phenomenon." [17]

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[15] Richard E. Spidel, "Court-Imposed Price Adjustments Under Long-Term Supply Contracts," Northwestern University Law Review, vol. 76 (October 1981), p. 380 The Emphasis is added.

[16] Charkes P. Kindleberger, *"A Financial History of Western Europe"* (London: George Allen & Unwin, Inc., 1984), p. 306.

The third misadventure in enforcing debt repayments was the case of Argentina, one of the few countries in Latin America that continued full debt servicing in the 1930's. The British were able to keep the Federal Government of Argentina on track with respect to debt servicing and were able to extract significant trade concessions as well. According to arguments heard today, one might expect that Argentina was well served later on by a favorable international reputation based on its "good behavior." The truth is precisely the opposite. The subsequent Argentine revulsion against foreign influence contributed to the rise to power of Juan Peron, a nationalist demagogue who did much to destroy both the Argentine economy and its international reputation over the succeeding decades.[18]

By 1943, the lessons were clear to the young analyst Henry Wallich. Writing about the overhang of defaulted Latin American bonds, Wallich had little doubt that these countries should be forgiven much of their debt burdens. Rather than arguing that debt forgiveness would debilitate the private capital markets, Wallich argued the opposite, that "a satisfactory settlement of the defaults would greatly improve the prospects of private foreign lending after the war." [19] He applauded the fact that the U.S. government did not apply pressures to get full servicing of the debt and noted approvingly that "apparently no attempt has been made to tie up the liberal [U.S. government] loans which began to be made in 1940 with demands for resumption of service to the defaulted bonds." [20]

From the 1940's to the 1970's, the major creditor countries continued to pursue the logic of debt relief rather than debt rescheduling when appropriate circumstances arose. An instructive case is that of Indonesia, whose turnaround in the mid-1960's is one of the greatest in the past twenty-five years. All of the right things happened in Indonesia: a hyperinflation was ended, a trade liberalization occurred, and economic growth and creditworthiness were restored. And the financial basis of the success was a generous and concessionary treatment of Indonesia's foreign debt.

When President Sukarno left the Indonesian government it was on the verge of bankruptcy and a hyperinflation that topped 1000 percent in 1966. After a civil war, a new military regime under President Suharto began to bring economic order to the country. The Suharto regime first received debt relief from the official creditors (in those simpler days the commercial banks were not involved) as of late 1966, when three years of grace on all principal and interest payments were granted. Moreover, the interest was not compounded, so that the postponement reflected substantial relief in present terms. In 1970, a standing committee of creditor governments, known as the Intergovernmental Group on Indonesia, was constituted to negotiate new terms with the Indonesian government. The specific nature of the agreement was as follows. The debt was consolidated, with principal to be repaid in thirty equal annual installments and interest, fixed at 3 percent, below market rates, to be repaid in fifteen installments, to begin after fifteen years (in 1986) and to run through the year 2000. The arrangement also permitted Indonesia to postpone up to three annual payments in the event of a shortfall in export earnings, following a precedent set in the 1946 Anglo-American loan agreement. The package, in all, represented substantial debt relief in present value terms and offered great flexibility for the country.

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[17] See Harold G. Moulton and Leo Pasvolsky, "*War Debts and World Prosperity*" (D. Appleton-Century Company, Inc., for the Brookings Institution, 1932), p. 306.

[18] The role of Argentina's foreign economic policy in Peron's ascension to power has been noted by several observers. Diaz-Alejandro put it this way: "The nationalist-populist coup of June 1943 . . . was able to revive memories of wounded national pride with notable domestic political success and with disturbing consequences for the international system" ("Latin American Debt," p. 389). See also Richard D. Mallon, in collaboration with Juan V. J. Sourrouille, "*Economic Policymaking in a Conflict Society: The Argentine Case*" (Harvard University Press, 1975), for a similar view.

[19] See H.C. Wallich, "The Future of Latin American Bonds," American Economic Review, vol. 33 (June 1943), p. 321.

[20] Ibid., p. 335.

The Indonesian operation was enormously successful. The hyperinflation ended in the late 1960's, and since that time, with the exception of debt problems of the state oil company in 1975, Indonesia's macroeconomic performance has been among the best in the developing world, combining high economic growth and low inflation rates.[21]

The settlement of Turkish debt at the end of the 1970's is another example of how generous terms for repayment of debt can contribute to economic recovery. Like Indonesia, Turkey represents a vital foreign policy interest of the NATO countries, an interest that was underscored in 1979 by the fall of the Shah of Iran. Between 1980 and 1983, Turkey therefore received a large package of support from the IMF, the World Bank, individual OECD governments (including $1.5 billion of concessional balance of payments support), and the Saudi Arabian Monetary Authority. That financial cushion obviated the need for Turkey to make large outward transfers to its creditors. Under its protective financial umbrella, Turkey has followed through on an ambitious program of trade liberalization and policy reform, which is now paying dividends in the form of strong export growth. Its experience contrasts starkly with that of Mexico, for example, which was required to make very large net resource transfers to the rest of the world after 1981. The trade balance of the two countries, in billions of dollars, is shown below:

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Turkey | −4.6 | −3.9 | −2.7 | −3.0 | −3.0 |
| Mexico | −2.8 | −4.1 | 6.8 | 13.8 | 12.8 |

## A STRATEGY FOR GRANTING DEBT RELIEF

The key to granting debt relief is to make it selective, so that not every debtor country feels the urge to suspend its international payments and so that the contractual basis for future international lending is not fundamentally undermined. For these purposes, I would propose simply that relief be granted according to a formula that both gives relief to the countries that, having experienced the largest declines in income, need relief the most, and minimizes the moral hazard that future borrowers will undertake policies with the goal of achieving debt relief. These criteria are the sort that creditors and debtors would select as contingencies that would modify the terms of the contract if they were negotiating with a clean slate. In order to minimize moral hazard problems, the relief should be granted only as part of an internationally supervised program of stabilization and reform. The case-by-case approach of the IMF and World Bank should be continued, but with financial arrangements that are much more attractive to the debtor countries than those now offered.

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[21] Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia."

Conditioning relief on income is problematic, since it does not distinguish between income declines that arise from exogenous factors, such as the terms of trade, and those arising from bad policies. However, in practice it would be difficult to make a more refined rule. For one thing, existing models are generally not good enough to track with precision the sources of a particular shortfall in income. Moreover, in a world of despotic regimes, in which the citizens of a country often have little control over the bad policies of the government, it is a good idea to put the lenders on notice that relief will be granted to the country if GNP falls, even if that decline is policy induced. In that way, the lenders are forced to monitor the actions of the despots in a way that the country's own citizens cannot. (Why should we endeavor to protect, after all, the sanctity of contracts between the banks and corrupt, unaccountable regimes like those of Videla of Argentina, or Marcos, or Bokassa, who, with the knowledge of the bankers, all used the loans for private gain?)

A workable basis might be to grant relief, on a progressive scale, to countries whose per capita incomes have dropped 15 percent or more relative to previous peaks. The relief to be granted would be a suspension of interest payments for a given period, without capitalization of the missed payments. The suspension should apply to all debts currently subject to rescheduling by the commercial banks and by the official creditors in the Paris Club. As a rough example, countries whose living standards, as measured by real per capita national income, have declined by 15–25 percent since 1980 would be permitted to forgo all interest payments for five years. Countries with a decline of more than 25 percent in living standards would forgo interest payments for ten years. (In reality the scales would have to be smoothed so that countries would not have the incentive to reduce incomes to earn more relief. Different degrees of relief on debts of differing vintages would have to be worked out. Moreover, considerations of the country's size, level of living standard, size of external versus internal shocks, and extent of hidden income through capital flight might be part of the formula.) In addition to the interest relief, I presume that all principal payments would be fully rescheduled for a period of several years.

Table 10 shows how this simple example would work for the Latin American economies through the end of 1985 based on an interest rate of 7 percent. The amount of bank relief shown is the present value of the skipped interest payments. Overall relief by U.S. banks in this example would total $6.6 billion; relief by all commercial banks, $19.1 billion. The forgiveness by U.S. banks would represent approximately 6.2 percent of U.S. bank capital. Presumably, regulators would allow the banks to amortize the write-off of the debt over several years to smooth the effects on the banks' earnings. For instance, income could be reduced simply as the interest payments are missed. For the African countries, the total U.S. bank exposure is approximately $4.7 billion. If interest is forgiven for an average of five years for all of the African countries, the cost to the U.S. banks would be on the order of $1.4 billion, or a little more than 1 percent of U.S. bank capital.

TABLE 10.—PROGRESSIVE DEBT RELIEF BASED ON DECLINE IN GDP, LATIN AMERICA, 1980–85 [1]

[In billions of dollars unless otherwise indicated]

| Per capita real GDP decline | Bank exposure | | Debt relief | | U.S. bank relief as percent of U.S. bank capital |
|---|---|---|---|---|---|
| | U.S. banks | Bank for International Settlements banks | U.S. banks | Bank for International Settlements banks | |
| 15–25 percent: | | | | | |
| Argentina | 8.7 | 27.8 | 2.7 | 8.6 | 2.6 |
| Peru | 1.5 | 5.2 | .5 | 1.6 | .5 |
| Uruguay | .9 | 2.1 | .3 | .7 | .3 |
| Venezuela | 9.8 | 25.8 | 3.0 | 8.0 | 2.8 |
| 25 percent or more: Bolivia | .1 | .6 | .1 | .2 | .1 |
| Total | 21.0 | 61.5 | 6.6 | 19.1 | 6.2 |

[1] Debt relief consists of a suspension of interest payments without capitalization of the missed payments. Countries whose per capita real GDP declined 15–25 percent from 1980 to 1985 would be permitted to forgo interest payments for five years. Countries whose per capita GDP declined by more than 25 percent would be permitted to forgo ten years of interest payments. The amount of debt relief shown is the net present value of the skipped interest payments. Calculations are based on an interest rate of 7 percent. Figures are rounded.

Source: Author's calculations as described in text. Bank exposure data are for end of December 1985. U.S. data are from "Country Exposure Leading Survey." BIS data are from Organization for Economic Cooperation and Development/Bank for International Settlements. "Statistics on External Indebtedness: Bank and Trade-Related Non-Bank External Claims on Individual Borrowing Countries and Territories at End-December 1985" (OECD/BIS: Paris and Basle, July 1986).

The following simple illustration shows the benefits of interest relief. For a country with a public debt—GNP ratio of 60 percent, facing a 7 percent interest rate, the annual interest burden is 4.2 percent of GDP. With investment-GDP ratios in Latin America on the order of 14 percent, interest payments represent about 30 percent of gross domestic investment.[22] Investment rates could rise by about one-third if the savings from debt relief were channeled towards higher investments. The easing of the budget burden would be on the order of 20–25 percent of central government revenues.

Given the significant benefits to be achieved by relief, would countries actually pursue poor economic growth in order to merit reduced debt payments? Almost surely, the answer is no. The countries in question have had historical per capita growth rates of 2 percent or more per annum. Thus, for per capita GDP to fall by 15 percent between 1980 and 1985, the decline relative to trend is on the order of 25 percent. The cumulative decline in output relative to trend is of course greater than 25 percent, since one must add together the shortfalls in output in each of the years between 1980 and 1985. Assuming that output falls smoothly by 3 percent per year during the interval, the cumulative output loss relative to trend is on the order of 75 percent of trend GNP.[23] There would also be further loss in the future as output recovers. These total losses must be compared with the gains to relief. Assuming a debt-GNP ratio of 60 percent and five years of interest relief, the present value savings are on the order of 18.6 percent of GNP.[24] The savings are obviously a small fraction of the GNP losses.

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[22] The investment rates for Argentina, Peru, and Venezuela in 1985 were, respectively, 11.7, 14.2, and 18.3 percent of GDP, according to data from DRI, Latin American Economic Review (DRI, Summer 1986).

For countries that have already suffered a significant, but less than 15 percent, decline in per capita income, it might pay to depress the economy for an additional short period to qualify for relief. There are two ways to ameliorate the problem. First, the extent of relief could be phased in gradually, rather than in one step. Second, when a government appeals for relief, its policies in the year preceding the relief could be scrutinized, as happens in bankruptcy proceedings, in order to disqualify countries that intentionally and flagrantly pursue bad policies for the sake of gaining relief.

## STRATEGIES FOR INCREASED CAPITAL FLOWS

About half of the debtor countries in Latin America, including the two biggest, Brazil and Mexico, would not qualify for relief under the standards illustrated above. What should be done for countries that might not be eligible for relief but that are nevertheless suffering seriously from the effects of the debt crisis? An effective strategy would be to encourage higher investment rates, based on greater foreign financial support, in order to spur recovery. Moreover, the predictability of that foreign support should be enhanced; otherwise, the banks and private wealthholders will continue to withdraw their assets from the debtor countries.

At present, new funds come entirely from existing bank creditors, who are already locked into a financial bind with the debtor country, and from the official creditors. The arrangement poses the continuing paradox that it is precisely those banks whose portfolios are filled with bad loans that are called upon to increase their exposures the most when the situtation deteriorates in one of the debtor countries. Since the banks have become increasingly reluctant to play this game, official creditors have more and more begun to bail out the banks, in the sense of providing net transfers into the country while the banks make net transfers out.

If the existing bank loans are indeed viable over the longer term and therefore should not be forgiven at this juncture, they will remain viable if the country borrows externally in order to spur investments, as long as those incremental investments have a rate of return above the incremental cost of borrowing and as long as the borrowing government raises internal revenues sufficiently to service the debts. For this reason, existing creditors should be willing, and indeed favorably disposed, to see new creditors enter the scene on a senior basis, if they can be guaranteed that the incremental funds will be utilized for profitable investment projects. Emphatically, the new lenders would not have to be banks. Senior lending could be made on the basis of marketable securities purchased by asset funds, multinational corporations, or private wealthholders, in addition to banks.

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[23] The deviation from previous trend would be 5 percent in 1981, 10 percent in 1982, 15 percent in 1983, 20 percent in 1984, and 25 percent in 1985, for a cumulative decline of 75 percent.

[24] See footnote 8, which showed relief to equal 0.31 of the fact value of the debt. Thus, relief relative to GDP is $0.31 \times 0.6 = 0.186$, or 18.6 percent.

My proposal would be to increase and stabilize the inflow of capital into the debtor countries by an arrangement that reschedules the existing debt while allowing new creditors to enter on the basis of seniority. The multilateral institutions would be in charge of monitoring the investment programs of the debtor countries to verify that incremental capital flows from abroad indeed increase national investment rates on the margin, a task that would necessarily involve conditionality on both the level of the macroeconomy and the public-sector investment budget. They would also be charged with defending the seniority interests of the new creditors by monitoring the arrangement that new debts get serviced before old debts. If the debtor countries resume their economic growth, as the commercial banks keep predicting that they will, then both the existing creditors and the new creditors will be repaid. If, on the other hand, the debtor countries continue to stagnate, then the existing creditors will find that their claims are even further reduced in value, so that the assets would have to be forgiven at some point. The approach has the virtue of not forcing a decision on the issue of forgiveness today, but rather allowing creditors and debtors to see whether an economic recovery materializes.

As in the case of debt relief, an approach such as this should be guided by clear and objective rules. For example, eligibility might be limited to countries that have suffered an absolute decline in per capita GDP during 1980–85. On such a standard, all of the major Latin American debtors would be eligible, with the exception of Colombia. The overall package would involve rescheduling of the existing debt, some new concerted lending by the existing creditors, and senior lending by new creditors in amounts that would be tied to the availability of worthwhile investment projects in the country. The concerted lending of the existing creditors should also be put on a more automatic basis. For example, the creditors might be required to put in 2.5 percent of existing exposure each year during the life of such an arrangement. They would then receive two-thirds of a 7.5 percent interest repayment, and relend one third. New lenders could be allowed to enter on a senior basis up to a yearly maximum of 5 percent of existing exposure, or more if the country has unusually attractive investment prospects. Finally, a country's participation in such a package should be conditioned on compliance with an internationally supervised adjustment program.

## CONDITIONALITY AND THE DEBT CRISIS

I have so far said little about how to tie a debt package to performance by the debtor countries. For one reason, my emphasis has been on the need to provide more financial support to the debtor countries; for another, I have less to quarrel with regarding conditionality than I do regarding financial support. Debt relief and debt reschedulings should continue to be tied to adjustment programs on a case-by-case basis as they are now. Policy reform is clearly needed to enable most of the debtor countries to resume economic growth and regain credit worthiness, and the provision of new lending or debt relief can be effectively and properly conditioned on such reforms being undertaken.

The major weaknesses of the current conditionality programs are two: they are underfunded and so ask too much for too little in return, and they demand unrealistically rapid reform. The same lack of realism is evident in the conditionality in the Baker plan, which emphasizes issues of microeconomic efficiency: opening up of foreign trade, privatization of state enterprise, and encouragement of foreign direct investment. Naturally, such liberalization efforts should be a part of a long-term economic adjustment program, but they must be expected to happen gradually, over a span of decades rather than a couple of years.

Indeed, the simple and sad truth about most attempts at rapid liberalization is that they do not succeed. Success tends to require a healthy macroeconomic environment, so that slower growth in sectors where protection is removed is balanced by higher growth in other parts of the economy. Also, in a growing economy, the "declining" sectors can decline in relative terms without having to decline brutally in absolute terms. Reductions in labor can then be accomplished through attrition rather than through layoffs. In the celebrated study by Anne Krueger of twenty-three liberation attempts from the 1950's through the early 1970's, only four actually succeeded in the long run.[25] And in all four cases, the initial macroeconomic conditions were vastly superior to the conditions now facing the major debtor countries.[26] The study also confirmed that liberalizations that do take hold are instituted gradually. The most celebrated instance of liberalization in the past thirty years is probably that of South Korea, which began to liberalize in the early 1960's. And yet after more than two decades of steady trade liberalization, nobody today would call Korea an example of a truly open economy. Its foreign trade regime is characterized by a rational tariff structure, a declining number of quantitative restrictions, and a unified and competitive exchange rate. But free trade it is not.

Perhaps the most troubling aspect of the recent emphasis on structural reform is the virtual neglect of issues of equity and fairness in the debtor countries. Income distribution in Latin America has widened significantly in the past ten years, as the wealthy have protected themselves through capital flight and low tax payments, while the poor have suffered the burdens of high inflation and economic austerity. Many of the basic problems of the Latin American societies are ones of fairness in the first instance. The creditor governments, and especially the United States, should insist that the debtor governments come up with fair and equitable burden sharing within their countries as part of the adjustment effort. How to do that, however, is best part of a long and separate discussion.

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[25] Anne O. Krueger, "Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences," A Special Conference Series on Foreign Trade Regimes and Economic Development, vol. 10 (New York: National Bureau of Economic Research, 1978). By the "long run," I mean up to the time of publication of the study.

[26] See Sachs, "Conditionality and the Debt Crisis: Some Thoughts for the World Bank" (Harvard University, January 1986).

## COMMENTS AND DISCUSSION

John Williamson: In my opinion the gloom in Sachs's assessment of where the debt crisis has got to is somewhat overdone. At least two countries that came close to having to reschedule, Colombia and Korea, have recovered impressively. Turkey is not the only country that rescheduled and has resumed voluntary borrowing: both Hungary and Yugoslavia also fall into the category. If Brazil can make the Cruzado Plan stick, it will almost certainly be judged sufficiently creditworthy to resume limited voluntary borrowing next year. One should also recall that more than 60 percent of the population of the Third World lives in countries, including India, that never did succumb to the debt crisis.

Similarly, Sachs measures the severity of the debt burden by the debt-export ratio in table 8. But the ratio of debt service to exports, at least as relevant a measure, has behaved much less discouragingly as a result of declining interest rates and long-term rescheduling. For example, the ratios for Argentina, Brazil, and Mexico have declined from 53 percent, 52 percent, and 36 percent, respectively, in 1982 to respectively 48 percent, 36 percent, and 30 percent in 1985. One can even find a few isolated cases that look hopeful in Sub-Saharan Africa, such as Botswana, Cameroon, Ghana, and Ivory Coast. And in Bolivia, while circumstances are indeed bad, they are certainly not as bad as is suggested by the official figure of a 28 percent decline in per capita GNP, which measures how much of the economy was forced underground, rather than how much of the economy was forced out of existence. So I think the gloom is overdone.

Nevertheless, it remains true that there is more than enough room for pessimism about the situation in many debtor countries. Two things have turned out worse than anticipated in earlier projections, such as those of William Cline.[27] One is the fall in commodity prices. The drop in the price of oil has posed a major problem for some of the debtors, although it has brought relief to others: overall it has probably made the debt problem worse rather than better. The other is the cutback in commercial bank lending. In 1983 the IMF's World Economic Outlook was forecasting a 1986 current account deficit in the nonoil developing countries of $93 billion, which presumably implied a belief that it would be possible to finance a deficit of that size. But the forecast in the October 1986 issue was $27 billion. The drop is clearly the result of the foreign exchange constraint, caused primarily by the unwillingness of the banks to resume lending.

It is therefore hardly surprising that discussion is turning to the question of debt relief. The banks have brought the prospect on themselves by their failure to act collectively to maintain an adequate flow of new lending. Even though his argument is not supported by much detail, I am convinced that Sachs is correct in claiming that under some circumstances both parties could gain from debt relief: the debt overhang is creating a set of incentives in the debtor countries that make it impossible to envisage new investment or, therefore, an expansion of nontraditional exports.

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[27] William R. Cline, "International Debt and the Stability of the World Economy" (Washington, D.C.: Institute for International Economics, September 1983).

Does endorsement of the principle of debt relief imply endorsement of the Bradley plan? As I see it, there are three features in that plan. The first is an increase of $40 billion to $50 billion in foreign aid over three years, financed by a tax on the banks. I have no problem with that part. The second element is essentially World Bank conditionality. On that my reactions are very similar to Sach's, namely that the principles are right but that the limit is too short and inflexible with too much pressure to liberalize trade in the short run rather than do it as and when balance of payments developments permit liberalization without income compression. The third feature of the Bradley plan is that it would provide something like 30 percent of the total relief to Brazil. Now Brazil is a country whose welfare would probably be jeopardized rather than promoted by gaining debt relief, because the benefit of the relief would be outweighed in present value terms by the loss in creditworthiness that would come about through accepting debt relief. On the other hand, the Bradley plan offers almost no relief to Sub-Saharan Africa, because Sub-Saharan Africa is not a major debtor to the commercial banks. Only $17 billion out of its over $100 billion total debt is owed to the commercial banks. For these reasons, I believe that Sachs is right to argue in favor of selective rather than general debt relief.

The Sachs plan has two elements. The first is temporary interest suspension for countries that have suffered major declines in real per capita income. How long the interest suspension would last would depend upon the depth of the preceding decline in income. An interesting historical precedent for interest suspension under adverse circumstances, besides the Indonesian case that Sachs cites, is the postwar loan granted by the United States to the United Kingdom in 1946. The loan's bisque clause, which allowed for interest suspension, was invoked a number of times.

The second element of the Sachs plan is the subordination of existing debt for all countries that have had any fall in real per capita income over a five-year period. The same proposal was advanced in the very early stages of the debt crisis by Jack Guttentag and Richard Herring.[28] Unfortunately it got little attention, perhaps because it was coupled with a number of other proposals, notably for the securitization of bank credit, that most of us did not feel were terribly necessary or helpful at that time. In any event, the more important proposal for subordination of existing debt did not get the discussion that it deserved. It should receive such attention now.

One major question that is not addressed by Sachs is whether official bilateral creditors and multilateral development banks should be treated the same as commercial banks. There are serious arguments against doing so, particularly in the case of the multilateral development banks. On the other hand, one has to recognize that if one does not extend the treatment to those forms of debt as well, then the benefits to most of Sub-Saharan Africa are going to be minor. Their problems simply will not be addressed, because most of their debt is to the official sector rather than to the commercial banks.

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[28] Jack M. Guttentag and Richard J. Herring, "The Current Crisis in International Banking" (Brookings, 1985).

How does the Sachs plan rate on the standard list of objections to debt relief? The first objection is that debt relief could risk a financial crisis. The argument here is typically that if enough relief is offered to address the problems of countries like Zambia and Bolivia, and this is then generalized to all debtor countries, that this will jeopardize the continued solvency of the major commercial banks. The answer is to make relief convincingly selective, to restrict it to the countries that really need it. If only interest suspension and not subordination would damage the financial position of the banks, as Sachs believes, then the Sachs plan is safe on this score. If, on the other hand, subordination of existing debt would have an adverse impact on the value of existing debt, the matter is not clear. If Sachs is right in arguing that new money will go voluntarily after subordination and that the new money will improve the possibility of countries developing new export sectors, then countries will actually be in a better position to repay the original debt than they otherwise would have been. Thus it could be that Brazil's existing debt will go up from, say 75 percent to 80 percent on the free market when the existing debt is subordinated. I am not at all sure that would happen, so there are some risks, though I think they are probably acceptable.

A second objection is that debt relief means a loss of access to future credit. The critical question here is the sign of the partial derivative of future credit availability with respect to current debt relief. The historical record is surely not as clear on this issue as Sachs claims. Indeed, I would have thought this is something that is going to differ from one country to another. I cannot, for example, believe that Brazil is going to improve its access to future credit by struggling to get relief at this stage. On the other hand, neither can I believe that Bolivia would not benefit in terms of its medium-term borrowing capability by having the slate wiped clean.

A third objection concerns moral hazard. Sachs's intention in choosing a fall in per capita income as the criterion for debt relief is to avoid countries taking deliberate steps to worsen their economies in order to qualify for relief. There is nevertheless some danger in a literal implementation of the Sachs plan, since by showing a 25 percent loss of per capita income instead of 24 percent, a country would be entitled to ten years' interest suspension instead of five. Of course a country would be unlikely to create a recession to gain relief, but it would surely fiddle its statistics. To minimize the problem one would need to smooth the schedule.

Fourth, there is the equity question. Restriction of the benefits to countries that have had a fall in per capita income attempts to address that issue, but there nevertheless remain two problems. One involves the moral obligation to compensate those countries that did not borrow. Some countries never borrowed anything except International Development Association money because they knew they were not capable of servicing anything else: Rwanda is an example. The second problem is that Sachs's criterion—a fall in per capita income—could provide relief to some countries whose claims, taking into account the bounty of their natural endowment, the value of their citizens' external assets, and the level of per capita income, are strictly marginal. Both Argentina and Venezuela would qualify for relief under his criterion.

A fifth possible problem is that wiping the slate clean reduces the incentive to adopt reform measures. However, as Sachs notes, one could avoid making this a once-for-all action, but rather impose conditionality over a series of years.

Finally, there is the legal problem. Can the commercial banks be persuaded to abandon their claims, or will it be necessary to write new laws in all of the creditor countries to enable some authority to direct the banks to reduce their claims? I agree with Sachs in his argument that too much has been made of this objection. There is, incidentally, one way in which the official sector could sanction debt relief and leave the commercial banks little choice but to acquiesce. It could exploit the IMF's authority to approve exchange controls. The Fund could, if it so wished, agree to a member debtor country imposing exchange controls that prohibited residents, including the public sector, from making interest payments to banks abroad. The controls would give legal authority for the suspension of interest payments to banks located in the creditor countries, except Switzerland. It would not, however, prevent the banks treating the unpaid interest as arrears; that would require legal action.

Last December I advanced a proposal for selective debt relief that was intended to enable the countries in the most desperate situation to get substantial relief, without thereby opening the floodgates so that Brazil and Mexico also qualified.[29] My proposal was to create an international tribunal that would be empowered to restructure debt, with the possibility of granting substantial relief where there existed a conjunction of circumstances. I suggested that perhaps five out of the following eight circumstances would be needed to qualify a country for relief:

—the occurrence of exogenous shocks that had led to a substantial unexpected increase in the burden of debt service;
—low per capita income;
—the lack of a threat to international financial stability;
—little prospect of the country being able to resume debt service without an unacceptable welfare cost;
—poor use made of the proceeds of the loan (this and the following criterion are intended to improve the incentives confronting the lenders, to ensure that in the future they undertake proper monitoring);
—irresponsible lending, in the sense of failing to make a serious assessment of the probability that the borrower will be in a position to service its debts;
—doubtful legitimacy of the government that contracted the loan;

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[29] John Williamson, "On the Question of Debt Relief," appendix to the Statement of The Roundtable on Money and Finance (Islamabad: North South Roundtable, December 1985).

—refusal of the lenders to extend further loans in support of an internationally agreed adjustment program;

—a presumption that economic recovery is being impeded by the debt overhang.

Sachs' paper inspires me to add two further criteria:

—a decline in per capita income;

—a presumption that economic recovery is being impeded by the debt overhang.

Sachs also persuades me that any debt relief tribunal should usually include the subordination of old debt in its debt restructuring award.

I am not convinced that Sachs's criterion of a fall in per capita income succeeds in doing what I argued explicitly no single one of my criteria could hope to accomplish—namely, provide a remotely satisfactory basis for discriminating between cases that do and do not merit debt relief. For that, one needs a series of criteria and a tribunal capable of combining them on a case-by-case basis. The only reason I can see for preferring Sachs's approach is the institutional and legal complexities of launching an international tribunal empowered to impose modifications in the terms of loan contracts on the lenders. I recognize that that reason may in the event prove decisive, since the need for selective debt relief is urgent. In any event, I am pleased that discussion is beginning to focus on the design of criteria and mechanisms for selective debt relief and escape from the dead end of advocating or criticizing generalized debt relief. Sachs has made a notable contribution to this crucial debate.

## GENERAL DISCUSSION

Several participants agreed with Sachs that some form of debt relief is appropriate. Stanley Fischer noted that the American banks continued to make large loans to the Latin American countries in 1980 and 1981, after it had become clear that repayment might be difficult. In his assessment, the banks' role in creating the debt crisis means that they should bear part of the costs of resolving it. Charles Holt suggested that Fischer's characterization of the banks' role may be somewhat too simple; in Holt's view, the governments of the industrialized countries, unwilling to offer direct assistance to the developing countries hurt by the 1979 OPEC price increases, put pressure on the banks to make loans. Holt speculated that avoiding future debt crises may require the creation of some mechanism for worldwide fiscal policy coordination. Matthew Shapiro suggested that debt relief would help not only the debtor countries but also the United States, in that relief would likely enable the Latin American countries to increase their imports of U.S. capital goods.

William Cline argued that the debt situation was not as dismal as Sachs depicted it. Falling interest rates have reduced interest payments on the debt in most countries. For example, Brazil's interest-to-export ratio has fallen from a peak of 52 percent to 31 percent. The aggregate interest-to-export ratio has not improved only because falling oil prices have hurt Mexico and, to a lesser extent, Venezuela. Moreover, experience suggests that nominal dollar commodity prices should eventually rise as a consequence of the recent fall in the real value of the dollar. Such a rise should help several of the debtor countries.

Cline also suggested that Sachs's argument for debt relief does not adequately come to grips with the negative impact that relief would have on access to credit markets for the countries accepting it. Cline attributed Mexico's and Brazil's strenuous efforts to avoid repudiating their debt to their concern about future creditworthiness. Peter Kenen countered that Mexico and Brazil were probably more concerned about possible retaliation, in the form of either trade sanctions or other nonfinancial sanctions. He also questioned whether the LDC government officials' actions reflect any rational calculus regarding their countries' interests. In Kenen's view, many of these officials acted out of a personal sense of partnership with their industrialized-country counterparts in a mutual effort to preserve the stability of the world financial system.

On Sachs's specific relief proposal, Robert Hall argued strongly against following a formula in granting debt relief. One reason not to use a formula is that the national income accounts kept by many of the debtor countries are simply not believable. A more fundamental objection, Hall continued, is that use of a formula would create incentives for poor economic performance. Hall preferred a strategy of tough talk, with relief to be negotiated as necessary on a case-by-case basis. Fischer suggested that, in fact, the United States is currently doing exactly what Hall recommends. He saw the recent Mexican plan as a good example of a fairly generous and imaginative package. Sachs questioned whether such an approach is really feasible over the long haul; tough talk would lose its credibility because any negotiated relief would become public knowledge.

Kenen suggested that it might be less costly to help Mexico and Brazil today, rather than waiting a year or two and taking the risk that current restrictive policies imposed by the lenders will lead to large cumulative declines in GNP that require more substantial relief. Kenen also suggested graduating the amount of relief according to the severity of each country's problems, but spreading all relief over a uniformly long time period. Sachs's plan would grant some countries relief over a very short period. Spreading all relief over, say, ten years would provide leverage for assuring that the debtor countries followed through on whatever actions they undertook as a condition for receiving relief.

Kenen went on to question the wisdom of making new loans to the debtor countries at the same time that relief is being granted on old loans. Making new loans to tide these countries over a bad patch made sense when the problem appeared to be a short-term one. It makes less sense now that it is clear that a lengthy adjustment lies ahead. Hall felt that some new debt might be a good idea, though he proposed a requirement that all new lending be to private companies rather than to governments. But Sachs pointed out that public spending on roads, dams, powerplants, health care, and so on, is complementary to private investment.

Kenen noted that subordination of old debt to new would be difficult both because the banks would be unwilling to agree to any scheme that subordinated their claims and because the involvement of parties from many countries would greatly complicate any negotiations concerning debt subordination. He also questioned whether such a scheme would actually lead to significantly increased loan inflows.

Cline contended that both the Bradley plan and the Sachs plan expected too much from the banks. Because the banks are highly leveraged, any relief would have a large adverse effect on bank capital. He concluded that any debt relief plan must involve public money as well as bank money.

Benjamin Friedman argued that any plan for dealing with the debt problem should also provide for bank write-downs of outstanding LDC debt. Such an approach might well force some banks to raise new capital at prices they found unattractive, but it would be preferable to the present policy that implicitly ignores the reduced value of bank portfolios and thus risks bigger problems in the future.

# DEVELOPING COUNTRY DEBT: IMPLEMENTING THE CONSENSUS*

By The World Bank

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## SUMMARY

The developing countries' outstanding debt recorded little growth in 1986. The steady decline in new lending evident since 1981 continued. Disbursements of long-term loans fell from $81.7 billion in 1985 to an estimated $72 billion in 1986. After principal repayments, net loan disbursements were reduced from $28.2 billion probably to around $21 billion. These net flows compare with approximately $50 billion interest paid by the developing countries in 1986.

TABLE 1.—THE GROWTH OF EXTERNAL DEBT, 1980–87

[In billions of U.S. dollars]

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 [1] | 1986 [2] | 1987 [2] |
|---|---|---|---|---|---|---|---|---|
| DRS reporting countries | 573 | 666 | 739 | 797 | 833 | 892 | 932 | 972 |
| Long-term debt | 430 | 494 | 551 | 630 | 673 | 731 | 775 | 812 |
| From official sources | 162 | 179 | 197 | 221 | 236 | 268 | 290 | 310 |
| From private sources | 268 | 315 | 354 | 409 | 438 | 463 | 485 | 502 |
| Short-term debt [3] | 134 | 158 | 167 | 137 | 126 | 124 | 118 | 160 |
| Use of IMF credit | 9 | 15 | 20 | 30 | 33 | 37 | 39 | |
| Other developing countries [4] | 77 | 83 | 86 | 93 | 96 | 100 | 103 | 108 |
| Long-term debt | 59 | 58 | 60 | 67 | 68 | 74 | 77 | 83 |
| From official sources | 17 | 18 | 20 | 17 | 20 | 23 | 24 | 25 |
| From private sources | 42 | 40 | 40 | 50 | 48 | 51 | 53 | 58 |
| Short-term debt | 18 | 24 | 25 | 25 | 27 | 25 | 25 | |
| Use of IMF credit | 0 | 1 | 1 | 1 | 1 | 1 | 1 | 25 |
| Total external debt | 650 | 749 | 825 | 890 | 929 | 992 | 1,035 | 1,080 |

[1] Data for 1985 are preliminary.

[2] Data for 1986 are estimated and for 1987 are projected.

[3] Data reflect the known rescheduling of some $45 billion of short-term debt to [illegible] into long-term debt in 1983-86.

[4] Includes data for developing countries that do not report through the DRS and for those that report in a form that does not admit publication in the standard tables; excludes debt of the high-income oil-exporting countries.

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*An abridged version of "Implementing the Consensus" from World Debt Tables, World Bank, February 27, 1987. Reprinted with permission.

The revision of terms to Mexico's 1984 rescheduling agreement, as part of a new financing package made necessary by the oil price collapse, proved a successful test of the international financial system's continued flexibility. But, this apart, the volume of debt rescheduled in 1986 remained at the significantly lower level of 1985, and new money provided under such agreements continued to fall.

Among different groups of debtor countries, the pattern of borrowing appears to have changed little from that seen in the detailed 1985 debt data. China remained a persistent and strong borrower, and other Asian countries continued to exploit their access to international credit markets, though, in many cases, less actively than previously. Of countries that have rescheduled debts since 1982, only Côte d'Ivoire and Uruguay have been able to raise long-term loans from financial markets outside the context of a formal restructuring agreement. In each case, new lending by commercial banks was part of a cofinancing arrangement with the World Bank.

Conditions remained very difficult for two groups of developing countries with serious debt problems—the highly-indebted middle-income counties and low-income Africa. Many of these countries have embarked on policy adjustment programs, but overall, they experienced no increase in external financing support in 1986. (See Table 3.) The decline in new lending continued. The projection for 1987 of a modest 4 percent increase to $1,085 billion in the total debt of all developing countries, including a further small increase due to currency effects, therefore, may still be on the high side.

## IMPLEMENTING THE CONSENSUS

A consensus developed in the course of 1985 on the need for a new approach to tackling the problems of the troubled debtor countries. It was based on the recognition that efforts to avoid a collapse of debt-servicing arrangements will eventually fail unless growth can be restored to the debtor economies. To date, most problem debtors have avoided a breakdown in their relations with creditors by adjusting to the high real cost of interest and the rapid contraction of new capital inflows through a combination of rescheduling and sharply reduced imports. For many, however, this has been done at the cost of stalled development and failing per capita incomes.

The restoration of growth to the debtor economies requires, first and foremost, adjustment to ensure adequate savings, to improve the return from investment, and, more broadly, to raise the efficiency of all resource allocations. It also requires sufficient demand in the world economy to absorb increased debtor-country exports. Finally, as proposed by James A. Baker, III, (in the United States Treasury Secretary's speech at the 1985 Annual Meetings of the International Monetary Fund (IMF) and World Bank in Seoul, Republic of Korea), debtor countries must be assured of adequate resources to support their adjustment efforts.

Although many debtor countries embarked on policy reforms or reinforced adjustment measures already in train in 1986, these conditions for renewed growth were not generally met. The collapse of oil prices early in the year gave welcome relief to oil-importing developing countries, but sharply reduced the export earnings of the oil exporters. Overall, it resulted in a significant shift of income from developing to developed econonmies. Contrary to expectations, this transfer did not result in faster growth in the industrialized countries. Demand for developing countries' exports remained sluggish, and commodity prices were again weak. The outlook early in 1987 is once again for slow growth of the global economy.

Shortage of external financing also continued to restrict most debtors' imports and added to the difficulty of adjustment. This continued shortage highlights a growing conflict between concern to preserve the old "burden-sharing" relationship between private and official creditors and the recognized need for additional financing. The focus on burden-sharing has tended to give financing flows maximum rather than minimum limits, as commercial banks have grown more reluctant to lead. This is a problem especially for the highly indebted middle-income countries, whose debt is heavily skewed towards private creditors.

TABLE 2.—IMPACT OF THE FALL IN OIL PRICES ON OIL-EXPORTING AND OIL-IMPORTING DEVELOPING COUNTRIES

[Dollars in U.S. billions]

| Country group | Revenue loss in 1986 [1] | Loss as a percentage of 1985 | |
|---|---|---|---|
| | | Exports | GNP |
| Oil exporters | $39.5 | 34.6 | 7.8 |
| Latin America | 17.3 | 30.8 | 6.9 |
| East Asia and Pacific [2] | 8.2 | 21.7 | 7.3 |
| Sub-Saharan Africa | 8.3 | 43.4 | 9.9 |
| Memorandum item: | | | |
| Highly-indebted countries | 22.7 | 34.2 | 7.2 |

| | Import savings in 1986 | Savings as a percentage of 1985 | |
|---|---|---|---|
| | | Imports | GNP |
| Oil Importers | $21.2 | 8.7 | 2.2 |
| Latin America | 4.4 | 6.4 | 1.2 |
| East Asia and Pacific | 5.3 | 9.5 | 3.4 |
| South Asia | 2.9 | 9.1 | 1.2 |
| Sub-Saharan Africa [3] | 1.1 | 7.5 | 2.2 |
| Memorandum item: | | | |
| Highly-indebted countries | 6.5 | 7.3 | 1.5 |

[1] Estimated oil exports for 1986 are based on 1985 volume and 1986 prices to isolate the effect of price changes.

[2] Excludes China.

[3] Excludes South Africa.

Note: The export revenues of individual oil-producing countries have been related to an average oil price of $27.80 per barrel in 1985 and $13.50 in 1986. Table excludes the high-income Middle Eastern oil-exporting countries; it includes sub-Saharan countries with outstanding debt (DOD) in 1985 of more than $0.5 billion and countries in the other regional groups with DOD in 1985 of more than $1.0 billion.

In the absence of faster export growth, the troubled debtor countries have little leeway to carry greater debts without adding to their servicing difficulties. Nevertheless, creditors would be turning their backs on the logic of the 1985 consensus, and on efforts to restore growth to the debtor countries, if weakness in the global economy and its effect on creditworthiness led them to abandon permanently the financing objectives endorsed a year ago. In the short term, adequate financing has become all the more important. Countries that commit themselves to effective policy reform programs, often carrying high political risks, should be assured of timely and adequate financing. Without that assurance, the growth focus of many countries' adjustment would be lost, and the risks of a disruptive breakdown of current debt-servicing arrangements would increase.

Ensuring adequate finance will call for careful but determined action by creditor governments. It is no solution to use public sector resources indiscriminately. Official lending must play catalytic roles, promoting and rewarding adjustment progress in the debtor countries, and facilitating and sustaining the contribution of private creditors. But if progress is to be made, the additional financing arrangements must be mobilized. If they are not, alternative and more damaging schemes for reducing the burden of debt service will gain ground.

Both commercial bankers and developing-country governments have become increasingly fatigued with complex and seemingly ever-to-be-renewed debt rescheduling negotiations and with the burdens put on both sides by the need to reach agreement with a multitude of partners. As banks have strengthened their financial ratios and feel themselves less exposed to the dangers of a breakdown (a phenomenon already noted in last year's World Debt Tables), they have stiffened their resistance to pressing appeals for new money unmatched by any clear prospect of renewed creditworthiness. For their part, the borrowers see yet another year of tight belts, continued net financial transfers to creditors, and no end to the tunnel. Moreover, personnel have changed on both sides, and the difficulty in concluding new agreements is increasing.

The paradox is that, even if from the limited points of view of individual creditors and debtors, these perceptions might seem correct, at least in the short run, they would be quite wrong from the point of view of the international economic system as a whole. The biggest and most lasting casualty of a conflictual breakdown of loan agreements would be the confidence indispensable to future economic and financial relations and the broad perception of a shared common interest in making the international economy work. At stake may be not only future financial flows to developing countries, but the preservation of the whole international economic framework, whose edges are already frayed by many tensions and disequilibria.

Resolving debt problems in a way that avoids conflict and reinforces the mutuality of debtor and creditor interests is thus a "common good," and warrants the coordinated intervention of national governments and international agencies through new public lending and through actions to strengthen private flows, both appropriately leveraged to reforms in the recipient countries. The balance between these two components should be determined case-by-case according to the extent of the problems faced by debtors and their willingness to act to overcome them. However, without the prior commitment of adequate financing and political goodwill by creditor governments to such a broad new approach, case-by-case progress is now increasingly at risk.

## A DIFFICULT YEAR FOR THE WORLD ECONOMY

The importance of growth as the key to resolving developing countries' debt problems was widely acknowledged towards the end of 1985. The consensus established then did not change in 1986. In the communiqué following its meeting in September, the Interim Committee of the Board of Governors of the IMF reiterated the "three basic requirements" for progress: effective policies in the debtor countries themselves; satisfactory growth in export markets and free access to them; and adequate external financial support.

Economic developments in 1986, however, have not made progress easy to achieve. The susceptibility of the world economy to continued shocks was felt early in the year with the sudden collapse of oil prices. Among developing countries, the effect of lower prices varied greatly. Countries like Nigeria and Venezuela, with over 80 percent of their export earnings coming from fuel exports, lost heavily. Others, such as Brazil and Turkey, for which petroleum had previously absorbed as much as a quarter of total import expenditures, derived important gains from the fall. Overall, however, lower oil prices brought with them a significant shift of income from developing to developed countries. Excluding the high-income Middle Eastern oil-exporting countries, revenue losses by developing country oil exporters [1] (based on 1985 export volumes) were estimated to be about $40 billion in 1986. By contrast, import savings for oil-importing developing countries were around half that level. In both sub-Saharan Africa and among the highly indebted countries (HIC's),[2] the losses of oil exporters greatly exceeded the savings of the oil importers. (See Table 1.)

Expectations that the transfer of income to oil-importing countries would give an early stimulus to global growth were disappointed. In present conditions, the immediate effect of sharp income transfers has been negative, enforcing a deflationary adjustment on those adversely affected, but inducing only a cautious response from those benefiting, almost exactly the reverse of the position a decade ago.

Economic activity in the industrial countries remained subdued in 1986. The pattern of slower growth in the United States, with little or no offsetting acceleration in the growth rates of Japan and the major European economies, continued from 1985. Despite the favorable balance-of-payments and inflation effects of lower oil prices, growth in these countries continued at well below 3 percent. This was too slow either to impart a strong demand for developing countries' exports or to reverse political pressures building in favor of protectionism in many developed countries. Illustrating the complexities of global interdependence, one of the causes of the disappointing growth of the industrial countries was the weak performance of their exports, notably to oil-exporting countries.

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[1] The oil exporters in this group include: Algeria, Cameroon, Congo, Ecuador, Egypt, Indonesia, Mexico, Nigeria, Syria, Trinidad and Tobago, and Venezuela.

[2] A group of seventeen middle-income developing countries with high debt and debt-service ratios that includes: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

Total world trade grew by around 4 percent in volume terms, slightly faster than in 1985. Developing countries' exports expanded at almost the same pace. However, commodity prices, with few exceptions, were again weak. Measured against the prices of manufactured exports, non-oil commodity prices fell by 10 percent in 1986 to their lowest level in at least fifty years.

Weak export earnings and a lack of external financing resulted in lower domestic demand, notably in many of the oil-exporting countries. Growth of gross domestic product (GDP) in the developing countries in 1986 slipped back from 4.6 percent in 1985 to around 3.8 percent. Low-income Africa, proved an exception, and was helped by better harvests and higher coffee prices to grow at 4.9 percent in 1986—the first year in the 1980s to see output growth exceed population growth. By contrast, the average growth of the HIC's in 1986 was barely 2 percent and would have been significantly less but for the inclusion of Brazil, which again grew rapidly in 1986. This average growth rate was somewhat less than the rate of population increase of these countries, which together account for nearly half of all developing countries' debts. It was also significantly below the real cost of interest on their debt.

## THE COMMITMENT TO ADJUSTMENT POLICIES

Not all developments in the international economy were negative in 1986. In the context of debt, two were especially encouraging: the continued fall of interest rates, and the commitment of adjustment policies undertaken by a wide range of troubled debtor economies.

Interest rates fell further than had been expected at the start of the year. The six-month dollar London Interbank Offered Rate (LIBOR) dropped from around 8 percent at the end of 1985 to 6 percent in the last quarter of 1986, its lowest level in nine years. Nominal interest rates also declined in most other international currencies, bringing an easing of industrial countries' real interest rates, though they remain high by historic standards. The fall in nominal interest rates was also welcome for the developing countries. However, their export prices also fell, and, adjusted for these, their average real cost of borrowing remained high, although experience within the average ranged quite widely in 1986.

*The Real Cost of Borrowing.*—While nominal interest rates fell to their lowest level in nearly a decade in 1986, real interest rates were in double figures for developing countries as a group for the sixth successive year. Real interest rates in this context are calculated by adjusting nominal interest rates for changes in the debtor's export prices. While of limited significance in any single year, this measure makes it possible to calculate the resource cost to the borrowing country of interest on its foreign currency debt.

In 1986, the dramatic fall in oil prices biased the real interest cost upwards for developing countries as a group and resulted in exceptionally high real rates for the oil exporters. While non-oil exporting countries, by contrast, experienced an improvement from the double-figure level of 1985, for most, the improvement was limited by the continued weakness of other commodity prices, and real rates were still around 6 percent, compared with 4 percent in the United States. In 1987, the likelihood of some recovery in average oil export prices should bring real interest rates for all developing countries below 10 percent for the first time since 1980, possibly well below, if other commodity prices stabilize—assuming no sharp reversal of the downward trend in nominal interest rates.

The commitment to adjustment policies in 1986 was encouraging, both in geographic coverage and for its scope within the debtor economies. Action to defeat rampant inflation and restore a stable macroeconomic environment, now widely recognized to be a precondition for sustainable growth, has dominated the approach of several Latin American countries. Argentina, Bolivia, and Brazil all achieved encouraging initial successes in breaking out of their inflationary spirals, though the difficult task of consolidating progress by holding budget deficits in check remains.

Equally fundamental to the renewal of growth is the need, faced by all countries embarking on adjustment programs, to improve the return from investment and ensure that resources are channeled efficiently to productive economic sectors. Public enterprise reform has been given priority in many countries, including Argentina, Côte d'Ivoire, Ecuador, and Nigeria, together with the reallocation of public investment away from areas more suitable for private sector enterprise and from projects with low returns. Several countries, notably Chile, have begun to return government-controlled companies to the private sector in order to improve competitive conditions and reduce budgetary outflows.

Trade policy reforms, aimed at reducing or removing disincentives to exporters, have also been quite widely introduced. To succeed, such changes need the support of exchange rates that give efficient signals to businessmen and other economic agents. Acknowledging this, many countries formally devalued their currencies sufficiently to obtain a lower exchange rate in real terms, while several others, such as Bolivia, Nigeria, Somalia, Zaire, and Zambia had recourse to regular foreign exchange auctions in order to give more effect to market pricing. In addition, agricultural reforms, involving the reduction or removal of subsidies and the reform of public buying authorities, and financial system reforms to encourage domestic savings and to improve the flow of those savings to efficient end users have formed an important part of many adjustment programs in Africa and Latin America.

The co-operation of the IMF and World Bank in formulating growth-oriented adjustment programs, in the context of supportive financial arrangements, has been an important factor in motivating and directing the pace of policy change.

## THE CONDITIONS FOR FUTURE GROWTH NOT YET ESTABLISHED

There was also a less welcome side to adjustment in 1986. In the absence of adequate financing support, many troubled debtor countries were again forced to cut imports in order to balance their external accounts. Brazil was a notable exception, supporting its economic growth by greatly increased imports (thus causing its trade surplus to dwindle). For most HICs, however, 1986 represented the fifth successive year of import reduction. In value terms, the imports of this group (including Brazil) in 1986 were little more than 60 percent of the 1981 level, Sub-Saharan African countries showed a similar pattern, with imports again down in 1986.

The success of adjustment programs cannot, of course, be judged in a single year. Policy changes require time to bear fruit, and progress is especially difficult to measure in the early stages and against a difficult external background. Nevertheless, the same concern that sparked 1985's consensus on the need for an active new approach to resolving debt problems remains a year later.

With regard to the global economy, the picture has changed very little. The pace of growth in the developed world is too slow to stimulate rapid expansion of developing countries' exports or bring about a reversal of the long decline in commodity prices that is needed for these countries to achieve sustained faster growth. Based on present policies, it appears that industrial-country growth will continue at no more than its 1986 rate of well below 3 percent. The prospects for reducing the current, very high levels of unemployment in the developed world, especially in Europe, are not encouraging. In these circumstances, markets for developing-country exports will continue to be difficult, and protectionist sentiment, which remained active in 1986, may gain new footholds that would then prove very hard to dislodge.

Faster growth is needed to raise demand for developing countries' exports. It is also needed as a signal to confidence, essential if the efforts of both debtors and creditors are to be sustained. On the debtors' side, many governments face mounting pressures to abandon reforms. To resist them, they need to believe that difficult policy choices will soon start yielding benefits in the form of a reversal of the past several years' declining trend of consumption and investment.

On the creditors' side, resumption of faster world growth is a precondition of confidence in the borrowers' ability to rebuild their creditworthiness. Flagging confidence has contributed to the decline of financing flows, not just from the peak levels of 1981, which (at least for commercial loans) few now believe to have been either appropriate or sustainable, but from the much reduced levels of 1983 and 1984. In 1985, both official and private lending fell sharply. Export credits were particularly depressed, contributing to the virtual halving of official bilateral disbursements (net of principal repayments) to 109 debtor developing countries,[3] from \$8.6 billion to \$4.7 billion. Lending from private financial markets fell, on the same basis, froim \$18.6 billion to \$11.9 billion. As Table 2 shows, the negative net transfer from all developing countries—the amount by which interest payments exceeded net new lending received—increased, from \$11 billion in 1984 to \$26 billion in 1985 on account of long-term loans.

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[3] Those reporting under the World Bank's DRS whose debt is included in the *World Debt Tables.*

TABLE 3.—PUBLIC AND PRIVATE LONG-TERM DEBT AND FINANCIAL FLOWS, 1980–86

[In billions of U.S. dollars]

| Long-term debt and financial flows | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 [1] | 1986 [1] |
|---|---|---|---|---|---|---|---|
| All developing countries: [2] | | | | | | | |
| Debt disbursed and outstanding | 429.6 | 493.6 | 551.2 | 630.2 | 673.4 | 730.9 | 775.0 |
| Disbursements | 102.8 | 122.8 | 115.8 | 96.5 | 88.3 | 81.7 | 72.0 |
| (From private creditors) | 74.6 | 91.3 | 83.9 | 63.9 | 56.1 | 52.1 | 41.0 |
| Debt service | 74.2 | 87.6 | 97.4 | 90.8 | 99.0 | 108.0 | 101.0 |
| Principal repayments | 42.0 | 46.5 | 48.8 | 44.0 | 46.3 | [3] 53.5 | 51.0 |
| Interest | 32.2 | 41.1 | 48.6 | 46.8 | 52.7 | 54.5 | 50.0 |
| Net transfers | 28.7 | 35.2 | 18.4 | 5.7 | −10.7 | −26.3 | −29.0 |
| Highly indebted countries: [4] | | | | | | | |
| Debt disbursed and outstanding | 204.1 | 244.4 | 276.5 | 329.2 | 354.0 | 367.6 | 382.0 |
| Disbursements | 53.2 | 69.5 | 60.1 | 39.7 | 32.3 | 22.4 | 21.0 |
| (From private creditors) | 46.0 | 60.9 | 50.9 | 29.7 | 22.5 | 13.6 | 12.0 |
| Debt service | 44.4 | 51.5 | 56.6 | 48.2 | 51.6 | 50.1 | 47.0 |
| Principal repayments | 24.6 | 26.1 | 25.8 | 19.1 | 18.4 | 17.1 | 16.0 |
| Interest | 19.8 | 25.4 | 30.8 | 29.1 | 33.3 | 33.0 | 31.0 |
| Net transfers | 8.8 | 18.0 | 3.5 | −8.5 | −19.4 | −27.7 | −26.0 |
| Low-income Africa: [5] | | | | | | | |
| Debt disbursed and outstanding | 26.3 | 28.7 | 30.7 | 33.3 | 34.0 | 37.3 | 40.5 |
| Disbursements | 5.4 | 4.8 | 4.1 | 3.9 | 3.1 | 3.0 | 2.8 |
| (From private creditors) | 2.1 | 1.5 | 1.2 | .7 | .4 | .4 | .3 |
| Debt service | 2.2 | 2.0 | 1.8 | 1.7 | 2.1 | 2.2 | 2.0 |
| Principal repayments | 1.3 | 1.2 | 1.1 | 1.0 | 1.2 | 1.3 | 1.2 |
| Interest | .9 | .8 | .7 | .8 | .9 | .9 | .8 |
| Net transfers | 3.3 | 2.7 | 2.3 | 2.1 | 1.0 | .8 | .8 |

[1] Preliminary for 1985; estimated for 1986.

[2] The 109 countries reporting under the Debtor Reporting System (DRS).

[3] Includes a $2 billion prepayment to financial institutions by Malaysia.

[4] For definition, see footnote 2, page xi.

[5] This series is not the same as that shown in last year's World Debt Tables since the country composition has changed. Sao Tomé, Senegal, and Zambia, now defined as low income, have been added. Cape Verde, classified this year as middle income, is excluded.

The decline in net new lending continued in 1986, and total capital flows to the developing countries (including direct investment and official and private grants) are unlikely to have increased over the 1985 level. Export credits probably enjoyed some recovery, and lending by the multilateral development banks, notably the World Bank, increased; however, lending by commercial banks, net of principal repayments, appears to have fallen significantly below 1985's depressed $11.6 billion level. As a group, the developing countries again paid substantially more in interest than they received in net new lending, despite lower interest rates. As indicated in Table 2, negative net transfers on account of long-term loans were possibly of the order of $29 billion in 1986 and were once again heavily concentrated on the HICs.

## RESCHEDULING LOSES MOMENTUM

The weakness of new commercial lending was matched by a disappointing lack of developments in rescheduling arrangements. Multi-year agreements have not evolved into a financial underpinning for medium-term adjustment programs, and their usefulness and purpose have increasingly been questioned. In both official and private sector reschedulings, where the need for future new money was clear, creditors have preferred to conclude short agreements and not address subsequent financing requirements until those particular bridges were reached.

For the private sector, this preference for "short-leash" arrangements is symptomatic of commercial banks' increasing reluctance to extend new loans to the problem debtor countries. For the public sector, it reflects limited endorsement of the role of multi-year agreements in official debt-relief arrangements (restructed to countries that can demonstrate a declining need for relief over the rescheduling period), and concern to maintain equality of burden-sharing among creditor groups. Reduced support for multi-year agreements has not been replaced by other techniques to expand the contribution of rescheduling to longer-term solutions of debt problems. In 1986, there was accordingly no recovery of momentum in the relief provided through rescheduling.

Another disquieting feature of 1986 was the concentration of commercial banks' new lending. Outside the $6 billion commitment to Mexico, $3.5 billion of which was due to be disbursed at the end of 1986, and a much smaller new money agreement with Nigeria, very little new lending went (or was promised) to the HICs. In part, this concentration was the result of circumstances. Lower oil prices seriously compounded the difficulties of the major oil exporters among the HICs. Increased lending became necessary, especially in Mexico's case, to avert a breakdown in foreign payments, as similar lending had been in the aftermath of the 1982 crisis. But it should not have preempted lending to other troubled debtor economies whose need for financing is equally pressing if a sustained setback to their development is to be averted.

The Baker proposals attempted to give a broader perspective to the financing support needed by countries committing themselves to the difficult long-haul process of structural adjustment. The response in 1986, however, appeared, at least in part, a step backwards to the firefighting approach of earlier days. The events of 1986 suggest that major creditor banks, on occasion, can still be persuaded to make new loans when faced with the imminent threat of collapse in their financial relationship with a major debtor (though even in Mexico's case it has proved difficult to bring smaller banks into the agreement). They offer no encouragement that a renewal of voluntary lending is close, and highlight the very real difficulty of harnessing private lending in support of longer-run adjustment programs.

That difficulty is increasing rather than easing. Bankers' attitudes have hardened with the passage of time and the perceived incentives for further lending have weakened. At one level, commercial banks' risk exposure to developing countries has fallen dramatically.[4] For the top twenty-four U.S. banks, it fell from 147 percent of capital to 118 percent in 1986, down from a high of 210 percent in 1981. For banks outside the United States, exposure figures are less readily available, but are known, in most cases, to be lower. The underlying strengthening of capital ratios is a welcome development for the international banking system, increasing its defences against future shocks, but its significance for lending flows to the debtor countries in the short term appears less favorable. At another level, the creditworthiness indicators (debt ratios) of most troubled debtor countries have continued to deteriorate since 1982, reflecting both the absence of growth in their economies and a number of technical factors discussed in last year's World Debt Tables. That deterioration has slowed since 1983, but it has not been reversed. Both indicators chart important motivations behind banks' lending: fear of the consequences of not lending in the case of the exposureratio, and the commercial attractiveness of new lending in the case of debt ratios. Both have been weakening.

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[4] In this context, risk exposure is measured by expressing the level of a bank's outstanding loans to developing countries as a percentage of its equity capital base.

## ENSURING ADEQUATE FINANCING

In these circumstances, the market, left to itself, will not provide the level of financing needed to sustain the debtor countries in their commitment to growth-oriented adjustment. New initiatives are required in the long-term self interest of all creditors, as they are of the debtors and of the international financial system as a whole. Yet such initiatives have become increasingly difficult to orchestrate, and unless official creditors give a determined lead they will not happen.

Measures to strengthen flows that do not create debt, especially equity flows, are desirable. The heavy emphasis on debt that characterized financial flows in the 1970's and early 1980's resulted in instability, as became clear after 1982. Developed-country governments and other official creditors can give a lead in this area, as the World Bank has done, for example, in establishing the Multilateral Investment Guarantee Agency (MIGA), which, at end 1986 had been signed by fifty-one governments from both developed and developing countries. Meanwhile, the debtor countries must continue strengthening the appeal of their economies to foreign investors, not easily done in times of uncertainty. New forms of finance need to be tapped, and flight capital must be encouraged to return. Debt conversion schemes constitute one interesting new vehicle for fostering these objectives, and several debtor countries now promote the swapping of external debt for domestic assets.

Progress in these directions will at best be slow, however, and the effect felt only over a number of years. On a similar timescale, other actions are also needed to make developing countries an attractive and appropriate home for surplus savings. Real interest rates on international lending must settle to a more sustainable relationship with the global growth potential; lending instruments should adapt in ways that contribute to greater stability in financing flows for development, including interest and repayment terms better aligned with the characteristics of developing-country investment; and the world trade environment must ensure competitive access to international markets.

Such issues are important if progress in resolving debt problems is to be sustained in the medium term. But the more pressing need is to keep countries on track in the short term with the financing they need to pursue adjustment programs fostering growth. For that, rescheduling must continue to play its full part in ensuring that the burden of debt service remains manageable, and there should also be increased lending on appropriate terms. Official creditors must lend more themselves, and they must work harder to engage the contribution of private creditors.

For low-income countries, especially those of sub-Saharan Africa, new finance must come mainly from official creditors and should entail varying, but high degrees of concessionality. For the middle-income HICs, the terms of borrowing are also important, but availability itself has become the critical issue. Commerical bank money must be part of the package for the HICs; there simply does not seem to be a way to reach the necessary totals without it. The emphasis of official effort should be to ensure the overall adequacy of financing, and concern with equitable burden-sharing among creditors, while important, should not get in the way of the minimal sharing by creditors of the debtors' adjustment burden. Debtor countries that commit themselves to programs of appropriate policy reform need and deserve the resources to make them work.

The 1985 consensus established the basis for progress in resolving debt problems. Agreement must now be followed by action. There is need to be sensitive to other objectives of official policy: not just the desire for equitable burden-sharing among creditors, but concern to minimize differences of treatment among debtors, and, above all, the wish to avoid encouraging imprudent behavior by either debtors or creditors. Sensible as these concerns are, they must not override concern to ensure minimum financing levels. The debtor countries have already paid a high price for excessive past borrowing, and lenders, too, have not been unscathed by the troubles experienced since 1982. Failure to create the conditions for growth-oriented adjustment would carry risks of a different and far more serious order: of a sustained setback to development in many debtor countries, of a growing breakdown in formal debtor-creditor relations, and of consequent lasting damage to the international financial system and world economy.

Some novel ideas have been tried and have proved successful, in particular cases, in raising the level of committed resources. The use of partial guarantees of private loans by official agencies is one example; the element of contingency financing in Mexico's 1986 agreement is another. Others have been canvassed. What is needed is not the ideas, but the determined action to put them into effect. The opportunity for doing this is not unlimited. Time is not easing the difficulties of the debtor countries. Moreover, the world economy has experienced an unusually long phase of growth since recovering from the 1981–82 recession. That growth is likely to continue in 1987, but the downswing of the cycle will not be avoided indefinitely. If a long-term solution to debt problems is not pursued vigorously while global conditions are broadly supportive, it may prove beyond reach as they become more difficult. The challenge of the 1985 consensus needs to be taken up in 1987.

# A PROPOSAL TO CREATE A SYSTEM FOR PART-PAYMENT IN LOCAL CURRENCY OF INTEREST ON EXTERNAL DEBT

By Victor L. Urquidi

The proposal is to allow the debtor countries to pay part of the interest due on their external debt in local currency which could then be used by the creditors for investments and loans in the debtor countries.

The purpose of this note is to propose the creation of a system for partial payment in local currency of the annual interest due on the external debt of the developing countries. Such payments in local currency would be made into restricted accounts to be held by the creditor banks in the debtor countries, and should only be used, via specified disbursement authorizations, to finance, also in local currency, development projects mutually agreed upon between the debtor and the creditor.

This is not a new idea, but it is surprising that in the course of international and national talks and meetings over the last few months, it does not seem to have been mentioned. The developing countries have been facing for some time a serious problem in trying to meet punctually the payments of interest on their external debt to the international banking community (mostly to private banks, but also, in certain cases, to officially-owned banks in some creditor countries). Some debtor countries have indeed been unable to meet their obligations on account of interest, and have postponed such payments, or in some instances defaulted.

Most of the international and bilateral discussions hinge upon the notion of a moratorium (agreed upon or unilateral), which is essentially a postponement sine die, or virtually a default on interest, while in respect of debt amortization attention is centered on rescheduling and restructuring of maturities.

Current discussions also include negotiating a reduction in the rate of interest, limiting interest payments to a specified percentage of exports, organizing financial "rescue" or "salvage" packages, and seeking new external financing—"fresh money"—from the creditor banks. The Baker Plan encompassess the latter idea, including conditionality in favor of freer trade and further opening of the economies of the developing countries to private direct foreign investment. The Baker Plan, however, has not been accepted by the creditor banks, nor is it sufficient to meet the present emergency, particularly since the decline in the world prices of basic products has continued (with the exception of coffee); in particular, the drastic fall in the price of crude oil has in effect jeopardized the present scheme of interest payments, whatever benefits the oil-importing countries may derive from it temporarily.

It would appear that important lessons of the past have not been taken into account, particularly the experience immediately after

World War II, when, under certainly different circumstances, the Marshall Plan was designed to enable a real transfer of resources to be made to Western Europe by the United States, in essence supplementary to the then limited ability of the World Bank and other financial organizations to help finance European reconstruction. The system now proposed for part-payment of interest in local currency takes a leaf from the Marshall Plan mechanisms set up to establish counterpart funds in Europe, in the local currencies. It is a somewhat different situation, but much can be learned from that experience.

During the 19th century, as well as after World War I, interest on external debt was usually paid, though not always punctually. If defaulted upon, it was later capitalized in debt reschedulings and new issues. However, interest payments were nominally quite low and were not seen as a serious problem. In practice, many borrowing governments had to issue their bonds considerably below par, and pay onerous commissions, so that in effect interest payments turned out to be rather steep. During the 19th century, and again in the 1920's, most debtor governments went into default on both interest and principal, and finally certain settlements were made—at the expense of the bondholders—that enabled creditworthiness to be re-established after World War II, at the time the World Bank was beginning its operations.

The controversy over World War I reparations (Keynes et al.) demonstrated beyond doubt that the defeated Germany could not pay such reparations except by means of a real transfer of resources, in the form of goods and services, that is, through an export surplus to the victorious Allied powers; and that had Germany been able to generate such a surplus, the beneficiaries of reparations would not have wanted to absorb such an increase in imports represented by that export surplus in settlement of reparations, even over a number of years. In fact, partial payments of reparations was made and then suspended, and we should not forget the political consequences at the time. The inter-Allied debts of World War I ran into the same difficulty, and they were not fully settled, even as late as the 1930's.

When the question of financing of the war effort arose at the time of World War II, these lessons were fully taken into account. The polemics among economists had not been in vain. The United States devised the Lend-Lease arrangements for its allies, so that money payments did not have to be made, nor did the resources have to be returned in money, but only in kind. This eventually occurred only in part; many Lend-Lease transfers to the allies were never settled. Great Britain's wartime debt to the United States was refinanced and finally settled, while the United Kingdom received new loans from different sources and finally was made a recipient of Marshall plan aid. It should be remembered also that the United States allocated, as approved by the Congress, close to 9 billion dollars to Marshall Plan aid in order to transfer real resources to Europe to help in its postwar reconstruction (some of the funds were spent off-shore, e.g. in Latin America). The United States also made available, under Congressional authorization, about 1 billion dollars for German reconstruction and 1 billion for Japanese reconstruction. Some years later, the United States put also about 1 billion dollars into South Korea for a similar purpose.

The central idea to bear in mind in connection with the present international indebtedness is that capital funds transferred to borrowers, and repayments of such transfers, have to have as their counterpart a real transfer of resources in the form of goods and services. During the 19th century, capital flows into Latin America from Europe translated into imports into the region of actual capital goods, as well as consumer goods and services, which contributed to development through railraods, power plants, ports, mining ventures, farming, food processing and other industrial activities.

In the case of the current external debt of the developing countries, which approaches 900 billion dollars, the real transfer has already been made during the 1970's, and especially during the early 1980's, largely in the form of capital goods and intermediate products, and also in the shape of military equipment and services. Unfortunately, a large portion—in certain cases an overwhelming one—of the transfer was made in consumer goods and services not essential for development, mainly as a result of currency overvaluation and spillover of domestic demand towards imports. And yet another large portion in effect financed capital flight, that is, took the shape of financial assets held abroad, as a consequence of a number of factors, among them overvaluation itself, and economic and political insecurity.

In the present circumstances, the payment of annual interest on the external debt of the developing countries is increasingly being treated by the latter not as a payment for a service but as a capital transfer abroad. This is because of the high real rate of interest at which loans were contracted or renegotiated, and also because the amount of such payments makes heavy inroads into domestic savings, both in the public sector and the private, that would otherwise be available for domestic investment. Thus, the $90 to $100 billion due annually on external debt must be treated as a capital transfer, that is, it can only be transferred from debtor to creditor countries through a real transfer of resources, by generating an export surplus of goods and services. This is hardly likely to occur to make repayments of principal possible. Some countries may, of course, be able to meet a large proportion, or all, of their interest payments. Others are far from being in that position.

The mechanism of the Marshall Plan is extremely instructive. Part of it was, of course, not a loan, but a grant. However, the counterpart funds derived from the sale of goods and services in Europe financed with Marshall Plan allocations remained in the European countries, in the local currencies, available for further recycling into the economic systems through loans and investments, thus contributing further to European reconstruction. Under PL 480 the U.S. Congress authorized a similar transfer system, whereby food was granted to a number of countries and the counterpart funds derived from the sale of such food were retained in local currency for further use in the beneficiary countries, for investments and loans for food production, research expenditures, and so on. Such counterpart funds, for the most part, were never transferred back to the United States in dollars.

It is hereby proposed that these ideas be applied, with such modifications and adaptations as may be appropriate, to the problem of payment of interest by the developing countries on their external debt. It is specifically proposed that agreements be reached with the international banking community to enable the debtors to pay part of the interest payments due by means of deposits in local currency in the local banking system. It would be necessary to determine what percentage of the interest payments would be deposited in the local currencies—say, pesos, bolivars, cruceiros, australes, dinars, rupees, etc.—, depending upon the terms, maturities and other features of each of the loans. For instance, payment in foreign currencies—dollars, marks, francs, sterling, yen, etc.—could be made for that portion of interest due represented by LIBOR less the current rate of inflation, while the difference, which in some cases could be as large as 6 to 8 percentage points, would be credited in the local currency. In other words, the real rate of interest would be covered in foreign currency, and the remainder in local currency. The portion to be paid in foreign currency would be met punctually and transferred immediately to the creditor banks; the portion payable in local currency would be credited to special accounts in the local banking system, which would be temporarily "restricted", that is, subject to disbursement only under special agreements and for financing in local currency.

Balances on the special accounts held in local currency would earn interest, in local currency also, at approximately the going rate of inflation of the debtor country, and would be available to the creditor banks for reinvestment in local currency, under conditions agreed upon with the debtor country government, to help finance specified development projects, e.g.: those that generate exports of goods and services or save foreign exchange; those that contribute to raising living standards in rural areas and in marginal urban zones; those that assist in improving education and training, and in raising health standards; those that contribute to increasing productivity and establishing quality control; those that contribute to improving environmental standards and conditions; and many others.

Loans and investments in local currency made from the special accounts held by the foreign banks would earn a yield to be agreed upon and payable, in a given, perhaps considerable proportion, in the foreign currency in which the older loans were originally expressed. It would be necessary to agree on what proportion of those loans, of new interest earned or of return on new investments, would be payable in foreign currency, under what terms and maturities, etc.

To manage the system proposed it would be essential that agreements be reached by the debtor countries with the multilateral financial agencies (World Bank, IDB, other regional development banks, perhaps also with the IMF), as well as with consortia of creditor banks in the countries in which these banks are based, in order to set up the machinery by which the new loans and investments in local currencies would be monitored, in accordance with the purposes set out.

Finally, the system could be tried out gradually and in limited form with a few banks in the United States, Europe and Japan, that may be specially interested and willing to collaborate with the developing countries in their development and in helping them to find practical solutions—positive and lasting ones—to the problem of payment of interest on external debt. It should be stressed that the system proposed is not an alternative to, or is submitted in opposition to, schemes for refinancing, for postponement of payments, for debt resructuring or rescheduling, or other mechanisms and schemes designed to lighten the debt burden, whether of interest or principal payments. It would be complementary to other schemes, and in time might become the most important mechanism in a new conception of the role of international capital in the development of the currently indebted countries. It would also contribute to preventing the collapse of the international financial and banking system.

On the other hand, for the countries heavily committed to austerity and readjustment programs, it would enlarge the potential for local financing of development, through the local banking systems, for increases in output and for new investments—and would moreover liberate foreign exchange that could be used to pay for imports of capital goods, intermediate products and technological services necessary for growth and development, thus contributing to the allocation of domestically-generated savings to precisely growth and development rather than merely transferring them to the treasuries of the international banking community. This community would not lose in the process, for it would have acquired claims which may turn out to be better than the wasted loans and investments of the past.

# THE INTERNATIONAL DEBT PROBLEM: OPTIONS FOR SOLUTION *

By Patricia Wertman

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*U.S. Library of Congress, Congressional Research Service, Oct. 17, 1986.

## ABSTRACT

Since the onset of the international debt problem in 1982, various proposals have been put forward for solving the problem. Some of the major proposals, including the "Baker Plan" and the Bradley proposal, are analyzed below. In addition, critieria for evaluating solutions to the debt problem are also suggested.

## THE INTERNATIONAL DEBT PROBLEM: PROPOSED SOLUTIONS

In 1982, many developing countries found themselves unable to service their international debt. The response was to provide additional financing in conjunction with economic adjustment programs to be carried out under the supervision of the International Monetary Fund (IMF). Four years later, it is clear that these austerity programs have only partly succeeded. Current account balances have improved dramatically. But debt levels are now higher than in 1982. The capacity to pay has not been improved, and creditworthiness has not been restored. Moreover, the austerity programs have had serious domestic consequences for the debtor nations. Economic growth in the developing countries in the 1980's has slowed dramatically. Per capita incomes have fallen sharply, and unemployment has risen. These consequences may well be unsustainable for the debtor nations.

The debt problem has also hurt the creditor nations. In order to generate trade surpluses, the debtor nations have severely compressed imports while simultaneously pushing exports. The resulting distortion of international trade patterns contributed to the enlargement of the U.S. trade deficit.

The continuing adverse impact of the debt problem on both debtor and creditor nations has led to a reappraisal of the strategy used in dealing with the problem between 1982 and 1985. The Reagan Adminsitration's reappraisal is embodied in the "Baker Plan." The Baker Plan as well as other solutions, which have been put forward since the onset of the 1982 crisis, are analyzed in this paper. The proposals are evaluated in the light of suggested guidelines which appear at the beginning of the paper. Particular attention is paid to how each proposal allocates costs.

## BACKGROUND

The build-up of debt by the less developed countries (LDCs) accelerated rapidly following the first dramatic oil price rises of 1973–1974. Borrowing abroad enabled non-oil producing developing countries to finance their oil imports and their development plans, while oil producing LDCs borrowed against anticipated revenues. In the inflationary environment of the 1970's, with a depreciating dollar and low or negative real interest rates, such borrowing was generally considered sound. Moreover, banks in the industrial nations were urged by their governments to "recycle" the petrodollar deposits of the oil exporting countries. According to the OECD, the pattern of borrowing which emerged during this period remained "comparatively strong and stable" until 1978.

The oil price increases of 1979 were the first of several economic blows which destabilized the existing borrowing pattern. In late

1979, the tightening of U.S. monetary policy in order to combat domestic inflation led to historically high real interest rates, both domestically and internationally, and to an appreciating dollar. Effectively, this meant that borrowing countries paid more on the debt which they had earlier contracted. Furthermore, the global recession of 1981–1982 diminished the exports of the LDCs and hence, their ability to earn foreign exchange. Moreover, with commodity prices dropping and the cost of their imports still rising, the terms of trade of the LDCs became increasingly unfavorable.

The LDCs began experiencing growing current account deficits.[1] Either economic adjustment leading to the reduction of these deficits had to occur or the deficits had to be financed by more borrowing. For the most part, the latter path was chosen and external debt continued to grow rapidly. As external debt reached levels which were unsustainable, the banks becames less willing to lend on a long-term basis. Thus, an increasing amount of Third World debt became short-term, setting the stage for a liquidity crisis caused by a sudden withdrawal of credit. In August 1982, Mexico provided the trigger for just such a crisis.

The Mexican financial crisis not only triggered the international debt crisis of 1982, but it set the pattern of response for handling the debt problem. This response has been primarily three-pronged, involving the International Monetary Fund (IMF), the commercial banks, and the debtor countries themselves. The IMF and the commercial banks provided financing while the debtor nations agreed to economic policy changes. These changes usually in fiscal, monetary, and exchange rate policies, were intended to lead to external adjustment. This three-pronged approach initially brought positive results; current account deficits were dramatically reduced.

As mid-1985 approached, the external debt situation of the Third World was again deteriorating, despite three years of adjustment programs.[2] Absolute debt levels were still rising, in part because of the nature of the debt rescue itself. Current account deficits, which dropped dramatically in both 1983 and 1984, rose slightly in 1985. The rate of increase of commercial bank lending to developing countries was slowing, actually declining in the first quarter of 1985, the first such decline since the Bank for International Settlements began collecting data in 1963. The countries themselves were finding it increasingly difficult to cling to the course of austerity as real wages dropped dramatically and unemployment mounted. Most important, U.S. economic growth, on which the level of LDC exports largely depends, had slowed. In these circumstances, many began to reappraise the existing approach to solving the international debt problem.

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[1] The current account of the balance of payments consists of the export and import of goods and services and unilateral transfers. A current account deficit is the amount by which a country's exports of goods and services and inward transfers fall short of its imports of goods and services and outward transfers.

[2] See U.S. Library of Congress. Congressional Research Service. Current Debt Servicing Capacity of the "Baker Plan" Fifteen. Report No. 86-641 E, by Patricia Wertman. Washington, March 31, 1986. 28 p.

## CRITERIA FOR EVALUATING DEBT PROPOSALS

This reappraisal not only brought forth the Baker Plan and the Bradley proposal, but is also suggested the need for a review of previously proposed solutions to the debt problem. The issues which the various proposals seek to address are many and complex, reflecting the debt problem itself. In an effort to sort through these issues and provide background for examination of the specific proposals reviewed in this paper some broad guidelines are developed here. These guidelines focus on the issues of costs and responsibilities, simplicity, flexibility, and commitment.

Politically, the most sensitive issue is the allocation of costs; it is also the most central of the four issues elaborated here. Basically, the issue is: Who pays the costs of a solution? A related issued is: How does the allocation of costs relate to the responsibilities of the participants in creating the debt crisis? What responsibilities do the participants have in solving the crisis?

Other questions which are addressed in this discussion of criteria and in the examination of individual proposals include: How simple is this proposal to implement? How flexible is it? Does it treat all debtors alike or does it recognize differences? Can the proposed solution adapt to adverse developments in the global economy? Is this a short-term solution or a long-term solution? Does it view the debt problem as a liquidity issue, a solvency issue, or both?

In addition, a matrix summarizing the major characteristics of the thirteeen proposals for solution which are examined here appears on page 4.[3] This is intended to ease comparison, as well as summarize the individual proposals. The characteristics selected for inclusion in the matrix are:

—limiting debt service,
—requiring an economic adjustment program of the debtors,
—creating a new agency or organization,
—containing an explicit or implicit creditor government guarantee,
—rescheduling debt or debt service,
—providing new financing,
—creating a new financial instrument,
—writing-off principal,
—creating a secondary market, and
—repudiating or defaulting on existing debt.

These characteristics are listed both here and in the table in order of their incidence, with recommendations to limit debt service being the most frequently recommended characteristic.

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[3] The proposed solutions examined in this paper were suggested by, alphabetically by last name: Secretary of the Treasury James A. Baker, Norman A. Bailey, Christine Bogdanowicz-Bindert, Senator Bill Bradley, Premier Fidel Castro, Professor Peter B. Kenen, Senator John F. Kerry, Lord Harold Lever, Felix Rohatyn, Representaive Charles E. Schumer, and Minos Zombanakis. In addition, a proposal by The Economist and an interest rate capping proposal are also examined. In the text of the paper, the proposals will be referred to by the last name of their author.

## CHARACTERISTICS OF DEBT PROPOSALS

| Proposal | Limits debt service | Requires economic adjustment program of debtor | Creates new agency/ organization | Explicit or implicit creditor Government guarantee | Reschedules debt/debt service | New financing | Creates new financial instrument | Writes off principal | Creates secondary market | Repudiation or default |
|---|---|---|---|---|---|---|---|---|---|---|
| "Baker Plan" |  | X |  |  |  | X |  |  |  |  |
| Bailey | X | X |  |  |  |  | X |  | X |  |
| Bogdanowicz-Bindert | X | X | X | X | X | X | X |  |  |  |
| Bradley | X | X |  |  |  |  |  | X |  |  |
| Castro |  |  |  |  |  |  |  |  |  | X |
| The Economist |  |  |  |  |  | X |  |  | X |  |
| Interest rate cap | X |  |  |  |  |  |  |  |  |  |
| Kenen | X | X | X | X | X |  | X | X | X |  |
| Kerry | X |  | X | X | X |  |  |  |  |  |
| Lever |  | X | X | X |  | X |  |  |  |  |
| Rohatyn | X |  | X | X | X |  | X |  |  |  |
| Schumer | X |  |  |  |  |  |  | X |  |  |
| Zombanakos | X | X | X | X | X | X |  |  |  |  |

## COSTS AND RESPONSIBILITIES

### *The Debtors*

The debtor countries are experiencing a net financial outflow.[4] Export revenues are falling. These financial constraints have required the debtor countries to continue to compress imports, achieved largely through decreasing aggregate demand by means of restrictive fiscal and monetary policies. The result has been little economic growth. Per capita incomes have fallen. The debtor countries cannot continue to sustain the high domestic costs imposed by the debt problem. Any solution to the debt problem needs, therefore, to ease financial constraints, allowing the debtors both to service their debt and to grow. This can be achieved either by increasing financial inflows or decreasing financial outflows or both. The Baker Plan depends on new financing. The approach suggests by most proposals, on the other hand, is to limit debt service. Finally, three proposals, most notably, the Bradley proposal, combine debt service limitation with a reduction of the debt level through a write-down.

The debtor countries, however, contributed substantially to the development of their external debt problem by pursuing unwise economic policies. A continuation of inappropriate economic policies would ensure the continuation of debt servicing difficulties. Thus, any solution to the debt problem needs to encourage and support the debtor nations in their undertaking of difficult economic reforms. The issues are the speed at which reform will occur and the extent to which it will be self-directed. While the debtor nations have frequently resented intervention by the IMF and other creditors, a lasting solution to the debt problem is likely to involve some form of monitoring or conditionality. Most of the proposals recognize this by requiring an IMF standby.

### *The Commercial Banks*

As Stuart Tucker has suggested, the banks have no interest in allocating costs fairly. Their concern is, appropriately, with their profits and exposure.[5] Moreover, healthy profits and a good capital base are the best insurance that the banks have of their ability to undertake the costs of the debt problem. The banks, therefore, will do whatever they can to evade the costs of the debt problem and protect their profits. Nevertheless, the banks have, in fact, incurred a considerable amount of the costs. They have sustained the losses associated with rescheduling and arrearages, and they have participated in involuntary new lending packages. They have done so in order to improve the quality of their assets.

Bank exposure in developing countries relative to capital is declining, although it remains considerable in the case of the money center banks. Moreover, the rate of bank lending to developing countries has slowed dramatically. The banks have apparently concluded that continued involvement in lending to the Third World is not attractive. They are, therefore, slowly extricating themselves from the LDC debt problem. Thus, the incentives to the banks to accept the costs of continued attempts to solve the international debt problem must, if anything, be greater than they were in 1982. In particular, the perceived, but non-quantifiable, improvement in the banks' assets must exceed the direct costs of a solution. Solutions which suggest a substantial write-down or significant interest rate relief are likely to be strongly resisted because their direct costs are likely to be high. Moreover, the banks will not swap assets unless the swap is attractive. Finally, they can not arbitrarily be deprived of their assets; bank participation must be voluntary.[6]

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[4] In 1985, long-term debt service exceeded new long-term lending by more than $20 billion. World Bank. World Debt Tables. 1985–1986 ed., p. xviii.

[5] Tucker, Stuart K. Statement contained in U.S. Congress. House. Committee on Banking, Finance and Urban Affairs. Subcommittee on International Development Institutions and Finance. Third World Debt Legislation. Hearings, 99th Congress, 2nd Sess. Washington, U.S. Govt. Print. Off., 1986, p. 177. (Hereafter cited as Tucker, Statement.)
Hearings held March 12, 18, 19, and 20, 1986.

Greater write-offs and reserve provisions have been taken by banks in other countries, operating under different regulatory regimes. In addition, more flexible regulatory guidelines have recently been applied to banks with problem farm and energy loans. This suggests that perhaps the best incentive toward solving the debt problem which could be offered to U.S. banks involves changes in the regulatory and accounting treatment of write-offs and the tax treatment of reserves. The Bradley proposal, in particular, suggests an examination of regulatory practices.

Finally, it must be emphasized that the commercial banks of the creditor nations are, in part, also responsible for creating the LDC debt problem. Appropriately, they should be expected to accept some of the costs of a solution. Any proposed solution which treats the banks too leniently will be subject to charges of "bank bailout," an issue which was frequently raised during the 1983 hearings on the proposed IMF quota increase. Moreover, any solution must recognize the problem of "moral hazard," that is, it must not encourage bank imprudence.

### *The Creditor Nations*

In the 1970s, the creditor governments encouraged the commercial banks to intermediate between the developing countries and the oil exporting nations which were building large financial surpluses. In so doing, the creditor governments helped to set the stage for the debt crisis of the 1980s. With the significant exception of the IMF quota increase in 1983, the creditor governments have, however, so far, largely resisted taking on the costs of a solution to the problem. Indeed, total official flows to the Third World have declined slightly since their peak in 1982.[7] Instead, the costs have been largely sustained by various parts of the private sector, including the exporting sector (such as farmers), which were not involved in creating the problem. The issue, therefore, is the distribution of costs between the public and private sectors of the creditor nations and among various segments of the private sector.

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[6] Cline, Williiam R. Bradley's Debt Plan Won't Work. Washington Post, July 17, 1986. p. A19.

[7] Total official flows from the creditor nations, which peaked in 1982 at $35.1 billion, declined marginally to $34.9 billion in 1984. OECD., Development Assistance Committee. Twenty-five Years of Development Co-operation: A Review. Paris, November 1985, p. 331.

Most of the proposed solutions are intended to foster economic growth in the debtor nations and, hence, increase their imports. This shifts the costs experienced by the exporting and manufacturing sectors of the creditor nations somewhere else. In many proposals, the cost is ultimately shifted to the creditor governments. Assumption of the costs of a solution by the creditor governments implies a more equitable sharing of costs within the creditor nation. It recognizes that the growth-retarding effects of the LDC debt problem have affected the entire nation. In addition, it also implicitly recognizes that the debt problem has foreign policy and strategic ramifications which are properly the concern of the nation as a whole.

The Baker Plan, in which most of the costs are assumed directly by the banks, is a major exception to the pattern of shifting costs to the public sector. Other proposals which are examined below shift the costs to the public sector by directly involving the creditor governments in the solution, for example, by guaranteeing bonds or by providing the capital for a new international institution. These proposals often recognize budgetary constraints by creating contingent liabilities rather than requiring direct budgetary expenditures. The Lever proposal, in particular, potentially shifts the costs to the creditor government by proposing that government export credit agencies insure private bank financing of LDC current account deficits.

Proposals for substantial write-downs, such as the Bradley and Schumer proposals, which appear to place the burden on the banks, may ultimately shift the costs from the private sector to the public sector by leading to a need for federal assistance to banks endangered by the resulting losses. Indeed, during the Continental Illinois Bank crisis of 1984, the Federal Reserve committed itself to preventing the failure of the largest U.S. banks. It is important to note that the Continental Illinois Bank crisis was sparked by large withdrawals based on rumors of significant losses. Thus, a major write-down which threatened the solvency of the money center banks could, in effect, temporarily result in the de facto nationalization of a significant portion of the U.S. banking system. In addition, such a commitment of government resources is likely to be open-ended.

Beyond any assumption of direct costs for solving the international debt problem, the creditor governments, particularly the United States, have a responsibility to create the kind of international economic environment in which a solution is possible. The level of international interest rates is particularly critical. Since international interest rates are closely tied to U.S. domestic interest rates, the debtor nations have frequently pointed to the U.S. fiscal deficit as the cause of high real interest rates. Recently, these complaints have been largely stilled by the decline in interest rates due to the easing of U.S. monetary policy. Nevertheless, from the point of view of the debtor nations and others, a more balanced mix of U.S. economic policies would contribute to a solution of the debt problem.

Another critical requirement for solution of the debt problem is economic growth in the industrial countries. Economic growth in the industrial countries provides markets for debtor nation exports.

As growth has flagged in the United States, the United States has pushed for more stimulative economic policies abroad, particularly in Japan and Germany. This attempt to achieve more balanced international growth through policy coordination among the major industrial nations, intended to ease the U.S. trade deficit, will also contribute both to easing the international debt problem and to world welfare. Finally, resistance to protectionism is also viewed as an urgent requirement for managing the international debt problem.

### SIMPLICITY

Existing mechanisms for dealing with the debt problem are cumbersome, straining the resources of both creditors and debtors alike. Any proposal which would simplify these mechanisms without undermining the ability to carefully structure an appropriate response to debtor problems could contribute to an easier solution of the debt problem. The Economist, for example, puts forward a pair of useful proposals which are based on existing mechanisms. They do not, however, represent a comprehensive solution to the debt problem. On the other hand, proposals which suggest the creation of a new international organization may perhaps delay a solution and bureaucratize the response to the problem. Moreover, the difficulty encountered in increasing IMF quotas in 1983 suggests that it may be very difficult to obtain support for the creation of a new international organization.

### FLEXIBILITY

All debt problems are not the same. In recognition of this, the international debt problem has been dealt with on a case-by-case basis since its onset in 1982. The Baker Plan continues this policy, as would the Bradley proposal. While universally applicable criteria, such as those suggested in the Kerry proposal, may facilitate solution, flexibility in dealing with individual debtor problems is likely to continue to be important. Moreover, any new solution must allow for unforseen and adverse developments in the world economy, such as a recession in the United States or a global increase in protectionism.

### COMMITMENT

Solution of the debt problem may well require sustained commitments to long-term finance by creditors and to economic adjustment by debtors. The international debt problem has lasted for nearly half a decade and has now become chronic. It is a solvency problem as well as a liquidity problem. Troubled debtors have not been restored to creditworthiness, nor are they likely to be soon.

Most of the proposals do not require long-term commitments. One-time stretch-outs, as proposed by Bogdanowicz-Bindert, Kenen, and Rohatyn, provide relief, but they may not free enough resources for debt service and development needs. They are also vague on the issue of new finance. Economic liberalization, a key aspect of both the Baker Plan and the Bradley proposal, also takes time and may also require sustained financial backing to achieve success. Finally, however, the failure of most proposals to structure a long-term solution may merely recognize political realities. Creditors and debtors alike may find making such long-term commitments extremely difficult.

## Proposals for New Financing

The proposals examined in this paper are grouped according to how the proposals provide financial resources to the debtor nations, that is, according to how they ease the debt problem. The debt problem can be eased either by increasing financial inflows or by decreasing financial outflows or by some combination of the two. The proposals in this section increase financial flows to the debtor nations by providing new financing. The Baker Plan and the proposal by the Economist largely represent an evolution from the pre-1985 strategy. The Lever proposal, on the other hand, is more original and would require alterations in the operations of existing institutions.

### THE BAKER PLAN

The first of the proposals to be examined here is the Baker Plan, the current policy of the Reagan Administration. The plan was dramatically put forward by Secretary of Treasury James A. Baker, III at the IMF-World Bank Annual Meeting in Seoul, Korea on October 8, 1985. Officially called "A Program for Sustained Growth," the proposal charts a new departure in terms of its goals. The steps outlined in the plan are seen as laying the groundwork for sustained economic growth enabling the debtor nations to "grow" out of their debts. The program is an attempt to move beyond the limitations of IMF austerity programs.

Reflecting this new emphasis on growth, the Baker Plan brings the World Bank (International Bank for Reconstruction and Development (IBRD)) and the regional development banks, such as the Inter-American Development Bank (IDB), to center stage in the debt strategy. This is a major departure for the current Administration which has sometimes been a harsh critic of the development banks. The Baker Plan proposes that they lend an additional $9 billion over three years to participating countries. The multilateral development banks are to increase structural adjustment lending, that is, policy-based lending in support of structural economic reforms, rather than their more traditional project lending. Sectoral lending and co-financing with commercial banks and other financial institutions are also expected to increase.

Under the Baker Plan the commercial banks will provide the bulk of the financing, lending $20 billion in new money over the three year period. This represents a yearly increase of about 2.5 percent over current exposure. Of this amount, $7 billion is to come from U.S. banks and $13 billion from non-U.S. banks.

Shortly after presentation of the Baker Plan in Seoul, the U.S. Treasury announced fifteen proposed participants: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. These countries have a combined debt of $438.2 billion. None of the fifteen have access to voluntary loans. Should they choose to participate, these nations will be required to undertake fundamental structural adjustments which are expected to enable them to grow out of their debt problem. Suggested structural economic reforms are to include such reforms as trade and investment liberalization, privatization of government enterprise, tax reform, elimination of government subsidies, and development of domestic capital markets.

The role of the IMF continues as before. It will continue to provide short-term (up to three years) financing in the exchange for macroeconomic adjustments by the borrowing nations, although it too will seek to place more emphasis on growth-oriented adjustment.

### *Analysis of the Baker Plan*

The Baker Plan is the only option for dealing with the debt problem currently receiving Administration backing. Like the preceding debt strategy, it is primarily designed to protect the U.S. banking system. Yet it has shortcomings. The World Bank and the other development banks probably have the financial capacity to generate $9 billion in net new loans over the next three years, but they may not have the institutional capacity and flexibility to extend this amount of new lending rapidly. The World Bank, in particular, is seen as having had leadership problems; its new President, Barber Conable, only assumed office in July 1986, making it too early to evaluate his impact. The Bank has also been accused of being slow-moving and bureaucratic: It (like the IMF) is on the brink of receiving more in interest and principal repayments from its borrowers than it pays out in new loans.[8] The Bank counters that this is in part cyclical and that the amount of time taken to process a loan ensures the quality of its loans and the viability of the projects which it finances.

Concern has been raised that the rapid expansion of lending might impair the World Bank's borrowing capacity or increase its borrowing costs (via a reduction in its AAA credit rating) and, hence, its future ability to lend. Moreover, the policy-based or structural adjustment lending, which the Baker Plan seeks to increase, is a comparatively new form of lending for the World Bank, although it is compatible with the Bank's microeconomic expertise. Finally, two recent sectoral adjustment loans, to Argentina and Brazil, have been controversial because they are intended to increase agricultural exports which would be competitive with U.S. exports. In any case, the World Bank has been moving ahead to extend the types of loans envisioned under the Baker Plan.

The Baker Plan was intended, in part, to counteract declining commerical bank willingness to lend to troubled Third World debtors. Despite this, the proposed $20 billion increase is modest. The 2.5 percent annual increase in the banks' exposure over three years would actually represent a decrease in lending in real terms. It is also lower than the rate of increase in the banks' capital, leaving them relatively less exposed. Moreover, $13 billion is supposed to come from non-U.S. banks, whose participation is not necessarily affected by U.S. Treasury persuasion.

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[8] Fleming, Stewart. World Bank on Brink of Taking in More Funds Than Go in Aid. Financial Times, June 23, 1986. p. 2.

In response to the request for additional lending, U.S. banks have reportedly asked for regulatory relief if they continue to lend to troubled borrowers. This request was apparently rejected. More important, by encouraging otherwise reluctant banks to continue lending, the Baker Plan raises the specter of a bank "bailout" should these new credits deteriorate.

Some argue that by inserting the U.S. Government as an active participant in the debt problem, the Baker Plan, *ipso facto*, also risks the politicization of the loan process. It is now the U.S. Government which is negotiating with the debtor nations rather than just the IMF and the commercial banks. Additionally, it involves the United States in the domestic economies of the debtor nations. Both of these aspects carry foreign policy risks for the United States.[9] Others, however, argue that the U.S. Government's role is much more limited than this, that it is acting merely as a coordinator.

A serious risk is that the Baker Plan may worsen the debt problem. A major component of the plan is $29 billion in additional lending from the commercial banks and the development banks, that is, $29 billion in additional debt for the fifteen borrowing nations. The plan assumes that the borrowers will be able to implement successfully the needed reforms in the three years allotted and that, at the end of the three years, they will be better able to service their debt. If, however, the reforms implemented by the participating nations are unsuccessful or only partially successful, the countries will emerge with a larger debt and no greater ability to service it. In short, their debt-servicing difficulties may increase. This would be particularly likely if global economic conditions becomes less favorable. In essence, it would also repeat the experience of the last three years. Some argue even more strongly that this outcome is, indeed, probable and that debt relief is, therefore, necessary.

A related criticism is that the funds provided may be inadequate. The fifteen proposed participants in the Baker Plan have faced high levels of interest payments—$44.5 billion in 1984 and $42.5 billion in 1985—and will continue to face high interest payments over the next three years. Meanwhile, exports were flat in 1985, due largely to a continued decline in commodity prices and a slowdown in the U.S. economy. Continued inability to increase exports could mean that the additional funds provided under the Baker Plan may do little more than help the debtor countries meet their debt service. Thus, with imports, including capital goods imports, already severely restricted, the additional financing provided by the Baker Plan may not be adequate to ensure the imports necessary for economic growth. The debtors may not, therefore, be able to "grow" out of their debt problem. Without this growth the debt burden will not be reduced relative to their capacity to carry it.

Although the debtor nations have welcomed the Baker initiative as a positive step, they have suggested that it fails to recognize fundamental macroeconomic issues which must be addressed if there is to be any lasting solution to the debt problem. These issues include continuing high real interest rates and the related issue of the U.S. fiscal credit, falling commodity prices, and protectionism. Specifically, the Latin American debtors, meeting in Montevideo in December 1985, proposed that real interest rates be lowered, that below-market rates of interest be applied to existing loans, that bank lending increase in line with inflation, and that debt service be linked to economic growth and trade performance.[10] While the Baker Plan proposes greater coordination between IMF and World Bank lending programs, the debtor nations have also opposed any possibility of cross-conditionality [11] between the two institutions—a possibility which they believe implies the imposition of stricter loan conditions.

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[9] Witcher, S. Karene. Risky medicine: Baker's Plan to Relieve Debt Crisis May Spur Future Ills, Critics Say. Wall Street Journal November 19, 1986. p. 1, 19.

*The Politics of the Baker Plan*

Fundamentally, the Baker Plan is a political initiative in which the United States Government makes no financial commitment. The United States has so far not even committed itself to a capital increase for the World Bank. Seemingly, the momentum of Secretary's Baker's dramatic call for action and support has been slackening. Secretary Baker asked for, and got, statements of support from the commercial banks. The statements came through the national banking groups; some of them came late and came reluctantly.

Like the banks, the debtor nations have also been welcoming but reluctant to fully embrace the plan. Debtor nation are wary of openly declaring themselves participants, apparently because the domestic political risks may be too great. Debtor governments apparently fear the appearance of undertaking difficult economic reforms at the behest of the U.S. Government. Unlike the banks, however, some of the debtor countries are quietly moving ahead with the kinds of reforms that the Baker Plan envisioned. Negotiations between most of the debtor nations and the IMF and World Bank are underway. The recently negotiated IMF loan to Mexico, with its emphasis on growth and its provisions for compensatory financing, is the first IMF loan to satisfy the conditions of the Baker Plan—a high-risk test case. Thus, while the Baker Plan has brought forth only reluctant public responses, it may be reinforcing a reorientation in the direction of economic reform in the debtor countries and in the pattern of adjustment financing.

## THE ECONOMIST PROPOSAL [12]

The Baker Plan has been Administration policy since October, 1985. Since the onset of the debt problem in 1982, however, there have been a variety of other proposals. The first of these to be considered there is by The Economist. In an editorial on April 2, 1983, the Economist put forward two proposals: "start a secondary market in converted bank loans, and let the IMF create an interest-rate CFF [compensatory financing facility]." Banks wishing to get rid of LDC loans could negotiate new terms with the borrowing country and then sell the newly-renegotiated loans on a secondary market. The CFF would provide compensatory financing in the event of an increase in international interest rates. It is this part of the Economist proposal which provides new financing.

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[10] Witcher, S. Karene. Latin American Debtors Display an Unusual Degree of Agreement. Wall Street Journal, December 23, 1985. p. 19.

[11] Cross-conditionality would involve coordination between the IMF and the World Bank on the conditions attached to their loans to individual countries. Such cross-conditionality would be intended to eliminate conflicting loan conditions.

[12] A Debt Partnership. The Economist, April 2, 1983. p. 9.

### *Analysis of The Economist Proposal*

A secondary market in LDC loans has, in fact, developed, although it does not involve renegotiated loans. Rather, the existing loans are sold or swapped at a discount. The size of this market was been estimated at $3 billion in 1984, a small fraction of total LDC debt.[13] The secondary market involves outright sales and swaps, with the greater part of the market consisting of swaps. In a swap between banks, the loans are swapped at a discount for cash and some high-yield debt to equal the face value of the loan. The difference in the discounts may also be made up in cash. Finally, a bank may sell a loan to an investor who then swaps the loan for equity shares in a local company or sells the debt to the central bank for local currency in order to make an investment.[14]

The secondary market has several advantages. It allows the banks to reduce or adjust their exposure. If exposure is reduced, it allows the banks to avoid related new money calls. It allows the debtor countries to purchase their debt at discount prices, thereby reducing the level of their debt and their future debt service. In the case of swaps by investors, it allows debtors to buy back their debt in local currency, important when foreign exchange is short, and it may provide the advantages of direct investment. Some countries, notably Chile, Mexico, and the Philippines, have programs to encourage debt to equity swaps.

There are also disadvantages to the secondary market: in the event of debt negotiations, the existence of substantial discounts in the secondary market can make new loans more difficult to justify and harder to arrange. Moreover, the size of the secondary market is limited by some important constraints. Banks fear that trading LDC debt at a discount may force them to take a loss on the remaining loans in their portfolio. In addition, a "notice to practitioners" from the American Institute of Certified Public Accountants recommends that, in the case of a swap where the assets are traded at less than the recorded value, the bank must take a loss.[15] This makes banks reluctant to participate in some swaps and, thus, limits the size of the market. Finally swaps to investors are limited by the investment laws of the host country and, possibly, by its economic condition. Investors are not eager to invest in a country whose economy is in recession, as has been the case in much of Latin America since the onset of the debt crisis.

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[13] Kristof, Nicholas D. The Market for Latin Debt: Quiet Growth of a Specialty. New York Times, July 17, 1985. p. D16.

[14] These aspects of the secondary market are described in detail in Latin Aerican Loans: Selling Them for all They're Worth. The Economist, March 2, 1985. p. 78. Debt to equity swaps are also explained in Berg, Eric N., U.S. Banks Swap Latin Debt. New York Times, September 11, 1986. p. D1, D5.

[15] Kristof, P. D16.

The marketing of Latin American debt as a tradable security, what has been termed "the ultimate junk bond,"[16] has also recently emerged. First Interstate Bancorp of Los Angeles has reached an agreement with a major Mexican bank, Multibank Comermex (Comermex), to convert $130 million in short-term loans into floating rate certificates of deposits. In addition, Drexel Burnham Lambert is also reported to be interested in developing a market in Latin American debt.[17] Securitization of banks debt raises problems similar to those discussed in regard to the secondary market. In addition, since bonds are usually excluded from debt reschedulings, bank holding loans of a country where some debt has been securitized may seek to be treated as equal creditors.[18]

The second part of The Economist's proposal involves the creation of an interest rate compensatory financing facility (CFF) within the IMF. The IMF's existing compensatory financing facility was created in 1963. It provides unconditional financial assistance to IMF members who are temporarily experiencing an export shortfall due to circumstances beyond their control. The CFF offsets the adverse effect of external conditions. An interest rate CFF would provide compensatory financing in the event of an increase in interest rates, which are internationally determined and, therefore, beyond the control of the debtor nations. Thus, an interest rate CFF would be consistent with the IMF's existing CFF.

An interest rate CFF meets a short-term problem, rising interest rates. It is not a basic solution to the debt problem. Moreover, the funds would be used to meet the increased interest payments rather than for purchasing imports and, hence, supporting economic growth. They would not improve the ability of the debtor to meet its debt service over the long-run.

## THE LEVER PROPOSAL[19]

Lord Lever proposes that the mandates of the government export credit agencies, such as the Export-Import Bank of the United States, be expanded to insure bank financing of the current account deficits of the debtor nations. Financing the current account would finance both trade and interest payments. A central agency to coordinate this current account financing would be established. It would inform the central bank of each developing country of the aggregate amount of insured current account financing available. The central agency would rely on the advice of the IMF in establishing the amount of current account financing to be provided. The central agency would also tally the amounts of financing provided by the individual export credit agencies so as to maintain the aggregate limit. Lever estimates that perhaps $40 to $60 billion in new bank credit would be required each year in the first year or two. In addition to its role in determining the aggregate financing limit, the IMF would also monitor adjustment programs with the leading borrowers.

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[16] Witcher, S. Karene. Selling Third World Debt as Securities Appeals to Bankers, But at What Price? Wall Street Journal, May 6, 1986. p. 31.

[17] Drexel Looks for Junk in Latin America. Euromoney, October 1985. p. 18.

[18] Witcher, S. Karene. Selling Third World Debt, p. 31.

[19] Lever, Harold. The International Debt Threat: a Concerted Way Out. The Economist, July 9, 1983, p. 14-16.

### *Analysis of the Lever Proposal*

By financing the current account deficits of the debtor nations, this proposal would support both economic growth and international trade. It achieves this, however, at a very substantial costs. The external debt of the debtor countries will rise very substantially, thus aggravating the problem. Moreover, this proposal is open to charges of "bank bailout." It would insure loans which are to be used, in part, to pay interest, thereby, effectively insuring funds which are "roundtripping." Thus, it also shifts the risk of balance of payments lending from the banks to the taxpayers of the creditor nations. Finally, the Lever proposal would significantly broaden the mandates of both the IMF and the export credit agencies. The debtor countries would undoubtedly resist IMF determination of the availability of financing and, thus, implicitly, of the size of their current account deficits, particularly when that determination is coupled with an IMF adjustment program. The IMF's role in this proposal is likely to be viewed by the debtor's extreme intrusion in economic policymaking.

## PROPOSALS FOR LIMITING DEBT SERVICE

The second group of proposals to be examined in this paper would ease the debt problem primarily by decreasing the outflow of financial resources from the debtor nations. The most common way of achieving this is to stretch-out debt service payments, that is, to lower the outflow of payments in any given year by stretching the payments out over a longer period of time. While these proposals would ease the situation of the debtor nations, they also involve a financial loss to the creditor banks. This loss occurs because of a decrease in the present discounted value of the debt service payments.

### STRETCH-OUTS

### *The Bogdanowicz-Bindert Proposal* [20]

In the July 11, 1983, issue of Business Week, Christine Bogdanowicz-Bindert, an economist with a New York investment banking firm, suggested the creation of an agency backed by the major industrial nations to take over some portion of the outstanding LDC debt from the banks. In exchange for turning over their loans, the banks would receive bonds from the new agency. The exchange would be at face value and the bonds would be priced at market rates of interest. Maturities of the bonds, however, would be suitably adjusted to the debtors' ability to pay. Interest and principal payments on the loans now held by the new agency would be made by the debtors to the new agency which would then use the funds to retire its outstanding bonds. In addition, the commercial banks would be required to extend new loans "sufficient not only to make current interest payments but also to support projects to stimulate

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[20] Bogdanowicz-Bindert, Christine. A Long-term Solution for LDC Debt. Business Week, July 11, 1983. p. 16. While this 1983 proposal deals comprehensively with the debt problem, Ms. Bogdanowicz-Bindert has also recommended limiting debt service, capitalizing interest, and partially writing-down the debt of small borrowers. See World Debt: The U.S. Reconsiders. Foreign Affairs, v. 64, no. 2, Winter 1985/1986. p. 259-273.

LDC recovery." Trade and interbank credit lines would be maintained at pre-crisis levels. Finally, efforts to boost the financial resources of the international organizations involved in attempts to resolve the debt problem, particularly the IMF, would continue. (This proposal was written before the 1983 IMF quota increase was approved.) In return for adjusted debt service payments and the new funds, the LDCs would have to adhere to IMF adjustment programs.

*Analysis of the Bogdanowicz-Bindert Proposal.*—The Bogdanowicz-Bindert proposal would be supportive of both economic growth and world trade. As she points out, "new funds are urgently needed for purposes other than debt service. . . . There is a limit to the squeeze that can be applied to the LDCs. Continuous deflation and negative growth cannot be sustained for long without serious political and social unrest." She also points out that "LDCs account for about 25% of exports from the member countries of the Organization for Economic Cooperation & Development. . . . The recovery of industrial countries is just as much at stake as the survival of the LDCs." By implication this proposal is also intended to reverse the outflow of funds from the Third World.

Bogdanowicz-Bindert also suggests that her proposal would strengthen the international banking system. This is less readily apparent. While replacing questionable assets with bonds which are ultimately guaranteed by the creditor nations would certainly strengthen the banks' balance sheets, the banks would also be extending new loans whose value is predicated upon the uncertain results of economic adjustment programs.

This proposal would provide substantial benefit to the banks, but at a cost. The banks would get to turn over their problem assets to an agency which is backed by the creditor governments, which are, in essence, providing a guarantee of repayment. The bonds which they receive are to be at market rates, even if the stretched out maturities imply a lower present discounted value then may have been the case for the original loans. In return, the banks would have to agree to new loans and the continuation of trade and interbank lines. They would have to continue to accept a degree of risk associated with continued lending to troubled debtors.

The proposal would establish a contingent liability of the creditor governments. Should the LDC borrowers be unable to sustain their payments to the new agency, the creditor governments would have to ensure that debt service on the bonds was met. Thus, it has the potentiality of shifting risk to the creditor nations.

While not elaborate, this proposal would, nevertheless, require the creation of a new international agency—not an easy undertaking in the current climate of fiscal austerity. The decision on what portion of LDC loans are to be eligible for inclusion in the new agency's portfolio might also be a difficult one.

### *The Rohatyn Proposal* [21]

In the February 28, 1983, issue of "Business Week," New York investment banker Felix Rohatyn put forth a proposal to establish a new international agency which would be guaranteed by the governments of the creditor nations. It would acquire the banks' LDC loans in exchange for its own long-term, low-interest bonds. The existing bank loans would then be rescheduled. For example, "$300 billion of existing short-term credits [could be] stretched out to 25 or 30 years, with an interest rate of . . . 6%. . . . Together with the remaining short- or medium-term debt, the schedule for principal repayments could be tailored country by country to reduce debt service costs to 25% to 30% of exports."

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[21] Rohatyn, Felix G. A Plan for Stretching Out Global Debt. Business Week, February 28, 1983. p. 15, 18.

*Analysis of the Rohatyn Proposal.*—Rohatyn was one of the earliest people to recognize the limitations of the debt strategy which evolved in 1982: "The present approach of insisting on IMF austerity programs while also keeping the borrowers under continuing crushing debt-service pressures could be self-defeating." Thus, Rohatyn was an early advocate of debt relief. Debt service payments would be limited to the ability to pay, 25 to 30 percent of exports.

Existing debt would be rescheduled, with short-term credit being stretched out and converted to 25–30 year bonds. As Rohatyn points out, this does not change the *economic* reality of the credits. The variable rate debt owed by the LDCs, though tied to short-term rates, is, in fact, long-term debt.

Rohatyn points out that "such a program might involve the recognition of significant costs and balance-sheet losses. A 25-year, 6% loan is worth considerably less, on its face, than a short-term, 13% loan. The allocation of such costs among bank stockholders, taxpayers, and countries would be the subject of difficult negotiations. . . The mechanism for such a stretch-out will not be difficult to construct once it is decided how to allocate the costs." This is precisely the issue: the allocation of costs.

In the Rohatyn proposal, the costs would be shared by the banks, the creditor nations, and the debtors. The banks would sustain a loss of current income because the interest income received on the bonds which they receive will be less than that on the loans which they formerly held. In return, the credits which they continue to hold would be more secure, and they are to be permitted to write-off some of these holdings over a longer period of time. The creditor governments would provide a guarantee of the new agency's bonds and would presumably be responsible for any financial shortfall which would be covered either, directly, by resorting to the capital of the agency or, indirectly, by allowing the agency to borrow on their capital markets. Finally, the debtor nations would still be responsible for paying 25-30 percent of the export receipts in debt service.

In passing, Rohatyn also raises an important issue, but addresses it only in the context of East-West relations. He asks: "Should commercial banks lend to foreign governments on a long-term basis, or should this be handled on a government-to-government basis?" In the case of loans to Communist countries, he suggests that these credits should be government-to-government. It is worth pondering, however, that credits to developing nations also raise strategic and foreign policy issues.

Finally, the Venezuelan government recently proposed consolidating $7 billion of approved private sector short-term credits and replacing them with government bonds maturing in 12 to 15 years and carrying an interest rate of 5 percent, that is, a below-market interest rate. This action was taken in response to bank pressure for the consolidation of private and public debt. It was greeted with outrage by the banks and resulted in the termination of some trade credits. The Venezuelan legislature is now reconsidering the policy. Nevertheless, the banks' response to the Venezuelan action suggests how they may react to similar proposals to consolidate and stretch-out existing debt.

### *The Zombanakis Proposal* [22]

On April 30, 1983, the Economist published a debt proposal by a noted international banker, Minos Zombanakis. The Zombanakis plan has two parts: a thirteen-year rescheduling of existing debt under the aegis of the IMF and the establishment of a Guarantee Loan Fund (GLF) within the IMF. The IMF would agree upon an adjustment program with the debtor country and, after a rescheduling had been worked out with the creditors, would undertake to guarantee repayments during the last three years of the rescheduled loans—years 11–13. If the borrower fails to comply with its program, the guarantees could be revoked. The rescheduled loans would bear interest rates comparable to those on government-issued or government-guaranteed paper. The difference between the original rate of interest and the new rate would be charged to the borrower as a guarantee fee. This guarantee fee would be collected in an escrow account to be used in meeting any need to pay out under the guarantee. The balance of any pay-out would be met by the GLF. The GLF would consist of stand-by letters of credit provided by the enlarged Group of Ten to the IMF.[23] Net payments would be repaid through the GLF, "under conditions to be worked out subsequently."

*Analysis of the Zombanakis Proposal.*—The Zombanakis plan is based on the belief that: "The real problem . . . is not just shortage of liquidity but, above all, the threat of insolvency both to countries and to banks." [24] Therefore, Zombanakis suggests a long-term solution designed to give the debtors breathing room "to make a realistic adjustment to a deeprooted problem that cannot be handled through short-term programmes and reschedulings." Like Felix Rohatyn, he is also, however, concerned with the problem of "wrongly structured maturities," a liquidity issue.

While the debtors would have their debt payments stretched out, they would not receive interest rate relief under the Zombanakis plan. The difference between the rates paid by the debtors on the newly rescheduled loans and the rates charged in the original loan would be paid by the debtors as a guarantee fee into an escrow account. This escrow account is to be used in the event of a pay-out under the guarantees. In essence, the LDCs would be shouldering part of the cost of the solution by providing part of the GLF. Moreover, the plan would keep tight rein on the LDCs by providing for constant IMF monitoring for the entire thirteen year period.

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[22] Zombanakis, Minos. The International Debt Threat: a Way to Avoid a Crash. The Economist, April 30, 1983. p. 11–14.

[23] The enlarged Group of Ten actually consists of eleven countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, Untied Kingdom, and United States.

[24] Zombanakis, Minos. The International Debt Threat, p. 13.

The Zombanakis plan would substantially enhance the role of the IMF, a situation which might not be greeted with universal acclaim. The IMF is to negotiate a "reasonable" adjustment program with the borrowers and, with the consent of the lenders, propose the rescheduling of existing debts. The GLF is to be established within the IMF. Moreover, the IMF can terminate the guarantees in the event that a borrower fails to comply with its program.

Under the Zombanakis plan the security of bank assets would improve, at a relatively small cost. The only loss which the banks sustain is associated with the long-term rescheduling of their loans at government rates.

At the same time, however, the Zombanakis plan is vague on the very important issue of financing for the adjustment process. While IMF financing would accompany compliance with an IMF program, perhaps giving rise to the need for an increase in IMF quotas, additional bank financing does not, however, appear to be guaranteed. Zombanakis suggests that, with the increased security of their loans, the banks "could resume their consideration of new requests from the borrowers—provided, of course, that these demands were within the framework of the new programme agreed with the IMF." Banks have been unwilling, however, to lend voluntarily to countries experiencing severe debt problems of the type which would make them eligible for participation in the Zombanakis plan. This plan appears to assume that successful adjustment will occur in the course of the thirteen year program and that, therefore, new bank financing will be voluntarily forthcoming. Such an outcome is not assured. Moreover, the fact that the banks would sustain a loss from the substitution of bonds for their assets would be likely to make them even more reticent to provide additional finance.

Lastly, the Zombanakis plan is a one-time remedy based on the assumption that "as world conditions return to *normal* [a country] will be able to repay its obligations." [Italic added.] Yet the history of the world economy in the 1970's and 1980's does not suggest normalcy, but rather instability. Unforseen events, such as the recent drop in oil prices, may make it difficult for the debtor nations to meet their rescheduled payments. In assuming a "return to normal," the Zombanakis plan does not provide for contingencies, except in so far as the IMF has the ability to renegotiate its programs.

## OTHER PROPOSALS

### *The Bailey Proposal* [25]

Norman A. Bailey, formerly of the National Security Council, has proposed that the central banks of the debtor countries issue negotiable Exchange Participation Notes (EPNs) in place of the principal repayments on existing loans. Debt eligible to be replaced by these notes would be limited to balance of payments loans; project loans and trade credits are specifically excluded from eligibility. The EPNs would give the commercial banks a pro-rata share of an agreed percentage of gross annual current account foreign exchange receipts. Interest payments "could be maintained in accordance with the original loan documentation, or assigned to the holder in due course of the EPN, or combined with principal in the EPNs themselves."[26] "The resources and activities of the BIS (Bank for International Settlements), IMF, creditor central banks, etc., would be directed primarily to keeping the debtors' interest payments current and thus maintain the liquidity of the international financial system."[27] EPNs would be redeemed by the debtors' central banks. Payments would be made through creditors' committees. The debtor countries would be required to have an IMF program.

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[25] Bailey, Norman A., R. David Luft, and Roger W. Robinson, Jr. Exchange Participation Notes: An Approach to the International Financial Crisis, in de Saint Phalle, Thibaut, ed. The International Financial Crisis: An Opportunity for Constructive Action. Washington, Center for Strategic and International Studies, 1983. p. 27-36. The proposal also appeared in Bailey, Norman A. A Safety Net for Foreign Lending. Business Week, January 10, 1983. p.17.

*Analysis of the Bailey Proposal.*—The chief beneficiaries of this program would be the LDCs, whose amortization payments would be tied to their foreign exchange earnings, that is, to their ability to pay. The percentage of foreign exchange allocated for servicing the EPNs could be set at a level consistent with providing debt relief. The proposal also has the merit of stretching out LDC debt payments.

The banks, on the other hand, would be assuming the risk of the LDCs' ability to generate foreign exchange. These risks would be, in turn, tied to the level of economic growth and protectionism in the industrial nations. The risk would be even greater if the interest payments are combined with the principal in the EPNs themselves. In effect, however, this is what the banks were doing in the first place when they extended balance of payments loans to the debtor countries. Unlike project loans, where the project generates a stream of earnings which enable repayment, and trade credits, which are self-liquidating, repayment of balance of payment loans have always depended on the availability of foreign exchange earnings. EPNs merely make this dependency more explicit. The realities of the source of repayment would not be changed. Since payments would be keyed to foreign exchange receipts, however, this plan also would create an incentive to under report foreign exchange earnings, as Bailey himself points out.[28]

The unpredictability of LDC current account receipts would appear to make the EPNs unattractive as a negotiable instrument and suggest that the EPNs would be likely to trade at a substantial discount, particularly in a recessionary world economy.[29] Although the plan does not explicitly provide for the creation of a secondary market in EPNs, it does appear to assume the development of one.

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[26] Ibid., p. 31.

[27] Ibid.

[28] Ibid., p. 32.

[29] Prices after discount for Third World debt trading in the secondary market in July 1986 were as follows: Argentina, 66 percent of face value; Brazil, 76 percent; Chile 67 percent; Colombia, 83 percent; Ecuador, 65 percent; Mexico, 56 percent; Venezeula, 75 percent; Poland, 45 percent; Romania, 90 percent; and Yugoslavia, 80 percent. Shearson Lehman Brothers figures quoted in The Debt Swappers. Euromoney, August, 1986. p. 71.

Such a market would permit the banks to adjust their Third World exposure and permit the debtors to buy back their debt at a reduced price. Should the secondary market, however, be glutted with EPNs, the banks may end up holding assets which are little more attractive than the original loans.

Under the Bailey plan interest payments would be maintained by loans from the BIS, the IMF, and the central banks of the creditor nations. These institutions would become the lenders of last resort, a role which some of them may be reluctant to undertake. More importantly, continued lending for the purpose of maintaining interest payments would involve an increase in debt levels so that the problem may be merely postponed. Furthermore, as Bailey himself points out "(m)aintenance of interest payments through the efforts of international institutions would require substantial amounts of money." [30] He does not say from where this money would come. The cost of maintaining the flow of funds to the debtor nations and back to the banks its apparently to be shouldered by the taxpayers of the creditor nations, making this plan likely to be subject to charges of "bank bailout."

Bailey himself points out that this plan would be difficult to implement and would require a degree of involvement in the financial affairs of the debtor nations which is "unusual in recent history and, therefore, may meet political resistance from some borrowers." [31] Indeed, it appears likely to meet borrower resistance.

### *Interest Rate Cap*

During early 1984, when interest rates were rising rapidly, several kinds of interest rate caps were suggested. The most common type proposed that floating interest rates be capped at a fixed level. When international interest rates rise above the fixed level, the interest differential between the two rates would be capitalized. When interest rates fall below the fixed rate, the borrower would continue to pay at the capped rate thereby paying off some of the capitalized interest.

*Analysis of Interest Rate Caps.*—The main advantage of this proposal is that it would protect the banks' profits. There are, however, several disadvantages. While the banks' profits would be protected, they would be, in effect, lending automatically, losing control of the terms of their loans. The banks may also find themselves lending below the cost of funds, a situation likely to result in a cut-off of lending. A universal cap would also fail to differentiate among borrowers. In addition, by removing the pressure of debt service, the interest rate cap may undermine the incentive of the debtor nations to adjust. Moreover, it merely postpones the problem and could prove to be expensive to the debtors. Finally, it may be a temporary solution which can only work if interest rates move downward within a reasonable time after rising.

### *The Kerry Proposal*

On June 26, 1986, Senator John Kerry introduced S. Res. 436, the "International Development Resolution of 1986." This resolution proposes that the U.S. representative to the United Nations seek an agreement which would limit debt service payments. The agreement would establish the "International Debt Program" (IDP) which would be managed by the International Trade and Finance Development Council. Debt relief would be directly related to an LDC's trade balance and structured so as to provide the LDC with an incentive to maintain or increase imports. In essence, the debt relief would provide the debtor nations with the funds for financing imports.

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[30] Bailey, p. 32.

[31] Ibid.

For countries with a trade surplus, a progressive cap on debt service payments would be established. Countries experiencing a trade surplus equivalent to 20 percent or less of their exports would have their debt service payments capped at 20 percent of exports. As the size of the surplus rises above 20 percent of exports, the amount of debt service payments capped increases. Thus, the greater the trade surplus, the less debt relief received. Alternatively, for countries with a trade deficit, a progressive scale of debt-service payments are to be automatically rescheduled. Countries with a trade deficit equal to 20 percent of exports would have 20 percent of their debt service payments rescheduled. As the trade deficit increases, the amount of rescheduled payments increases to a maximum of 40 percent.

Debt relief would apply to public and publicly guaranteed debt. Rescheduled debt service payments would be capitalized. During the first five years, interest payments on the rescheduled debt service would be paid by the IDP. During the next ten years, a fixed interest rate of 3 percent would be paid by the participating debtor nations. The difference between the 3 percent to be paid by the debtor countries and market rates of interest would be paid for by the IDP. The program would be financed by the creditor nations according to the trade benefits derived. The participating debtor nations would establish a reserve against default equivalent to 10 percent of the debt relief received. Finally, the agreement would end after five years.

*Analysis of the Kerry Proposal.*—The Kerry proposal is comprehensive and complex. The basis for this resolution is contained in a study by Brazilian Professor Eduardo Dutra Aydos. This study was inserted in the Congressional Record of May 7, 1986 by Senator Kerry.[32] The very complexity of this proposal may make it difficult to implement.

Like the Bradley proposal which is discussed below, the Kerry proposal recognizes the intimate linkage between trade and debt. Thus, the Kerry proposal seeks the balancing of gross trade flows. Specifically, it does this by providing enough debt relief to maintain or increase the level of imports. In doing this it recognizes the adverse impact on creditor nations of the cutback in LDC imports.

The Kerry proposal is also growth-oriented. By allowing the debtor nations to maintain or increase their imports it also allows them to foster their economic growth. In this way, it will reduce the level of the debt burden relative to the size of the debtors' economies and their ability to pay.

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[32] Kerry, John. A Way Out of the Debt Crisis. Remarks in the Senate. Congressional Record [daily ed.] vol. 132, May 7, 1986: S5584–S5589.

The Kerry proposal has the flexibility of the case-by-case approach, but the predictability of universally applied criteria. The criteria are, however, based upon the reporting of trade results, thereby creating an incentive to inaccurate reporting. Participating countries would have an incentive to underreport exports and overreport imports. Moreover, in many instances, the trade figures are already distorted as a result of capital flight.

The Kerry proposal would treat the commercial banks relatively generously. The Kerry proposal does not involve a write-off of LDC debt. The banks would receive full payment of interest and principal in return for the elimination of spreads and fees. But they would sustain some loss in the rescheduling process because of the time value of money. Moreover, the proposal would further protect the banks by establishing a loss reserve equal to 10 percent of the value of the debt relief, a proposal which would effectively reduce the amount of relief and which may, therefore, be resisted by the debtor nations.

On the other hand, the Kerry proposal would make society at large in the creditor nations pay the costs of a solution to the LDC debt problem. In so doing the proposal implicitly acknowledges that the international debt problem is adversely affecting large segments of the creditor nations' economies, as well as total economic growth. The proposal suggests that the program is financed by an import tax or, possibly, by budget appropriation. In any case, it would be the consumers or the taxpayers of the creditor nations which would pay for the costs of the program. It is not yet clear that any nation is ready to do this.

Finally, the Kerry proposal is not explicit regarding the responsibility of the LDCs to improve their economic management. Perhaps the inclusion of the World Bank, the IMF, and the GATT on the Board of Directors of the International Development Council, the proposal's administrative body, is intended to address this problem. Without economic reform, the debt problem is likely to continue despite the very substantial debt service relief which the Kerry proposal would provide.

## PROPOSALS COMBINING DEBT SERVICE RELIEF AND WRITE-DOWNS

The proposals discussed in this section would also ease the LDC debt problem by decreasing the financial outflows from the debtor nations. In addition to limiting debt service, however, they also provide for writing down the principal on the outstanding debt. This would both lower the outstanding debt and debt service. Most of these proposals, therefore, would potentially involve greater losses for the commercial banks than the debt service limitation proposals discussed above.

### THE BRADLEY PROPOSAL[33]

On June 29, 1986, Senator Bill Bradley put forth "A Proposal for Third World Debt Management" in a speech in Zurich, Switzerland. Bradley suggested that the President of the United States convene a "trade relief" summit. Senator Bradley proposed that this summit be held annually in conjunction with the first three years of the new round of multilateral trade talks which are to be held under the auspices of the General Agreement for Tariffs and Trade (GATT). The proposed summit would be chaired by World Bank President Barber Conable. Commercial bank and government creditors would be equally represented at the summit, with at least three representatives each in attendance.

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[33] Bradley, Bill. A Proposal for Third World Debt Management. June 29, 1986. 5 p.

The trade relief summit would provide interest rate and debt relief to the fifteen debtor nations which are currently included in the Baker Plan. Senator Bradley suggests that the targeted amount of yearly relief equal 3 percentage points off interest rates plus a 3 percent writedown of principal on all outstanding commercial and bilateral government loans. The exact amount of relief would, however, be negotiated with each participating country. Senator Bradley suggests that full participation by the Latin American dedtors could result in $42 billion in debt relief. For their part, the debtor nations would undertake reforms to restore economic confidence. The debtor nations would liberalize trade, reverse capital flight, encourage intenal investment, pursue policies which promote economic growth and have broad political support, and keep debt management free of scandal. Finally, the international development banks would extend $3 billion annually in project and structural adjustment loans.

### *Analysis of the Bradley Proposal*

The Bradley proposal not only recognizes the importance of economic growth, as does the Baker Plan, but also considers several other important aspects of the international debt problem. In particular, it forcuses on, what Senator Bradley terms, the most "perverse" aspect of the problem, that is, that the debtor nations are sustaining a net capital outflow to the creditor nations. This position is inherently unsustainable for developing countries. Developing countries must have capital to grow. Since they are unable to generate the needed savings domestically, they must receive a net capital inflow from abroad. By reducing interest and principal payments, the Bradley proposal seeks to relieve the financial outflow from the debtor nations.

The Bradley proposal recognizes the important link between trade and debt, although terming the summit a "trade relief" summit obscures its main thrust: It would be "debt relief" summit. Nevertheless, by focusing on the connection between debt and trade, the Bradley proposal would offer something to both debtor and creditor nations. Economic growth in the debtor nations has been lowered. Severe import compression and aggressive export promotion by the debtor nations have seriously distorted international trade patterns. The trade deficit of the United States has been widened by the impact of the debt problem. Employment losses in some sectors in the creditor nations have led to greater protectionism. By providing debt relief, the Bradley proposal would attempt to ease these pressures.

The Bradley proposal also recognizes an important political reality: the governments of the debtor nations are finding it increasingly difficult to gain the support of their electorates for painful economic reforms while, at the same time, agreeing to increases in the very debt burden which is the crux of their problem. The Bradley proposal offers hope for the future. By reducing the debt burden, it would place the debtor governments in a better position to argue for support of difficult economic measures.

The Bradley proposal suggests $9 billion in additional loans by the World Bank and the regional development banks. While such loans are made at below-market rates of interest, they, nevertheless, increase the debt burden of the recipients, as in the Baker Plan.

The Bradley proposal differs significantly from the Baker Plan in its treatment of the role of the commercial banks. The Bradley proposal does not ask the commercial banks to make any new loans. It recognizes that the banks have been reducing their exposure in Third World countries. Instead, the banks are asked to reduce interest payments by 3 percent over a 3-year period and accept a 3 percent reduction in outstanding principal annually for 3 years. Such deep interest rate cuts would result in loan rates below the banks' cost of funds—a situation which the banks are unlikely to accept without offsetting compensation. Moreover, an annual reduction of 3 percent of the $280.3 billion commerical bank debt of the Baker Plan Fifteen would be equal to about $25 billion. $89.1 billion or approximately 32 percent of the total commerical bank debt of the Baker Plan Fifteen is owed to U.S. banks. On a pro-rata basis, the annual 3 percent write-off of principal suggests a cumulative loss for U.S. banks of about $8 billion, equal to about 7.3 percent of their total primary capital (equity, subordinated debentures, and reserves for loan losses, currently equal to $109.7 billion.)[34] This is a large loss—and it would be on top of the loss sustained by granting interest rate relief. This loss would be heavily concentrated in the large money center banks. Finally, however, it must be emphasized that Senator Bradley has indicated that "[t]he precise numbers aren't all that important, but the concept of debt relief is [important]."[35]

U.S. banks have been considerably less aggressive in writing off their LDC loans than banks in some other countries. Regulatory disparities between countries account for much of this difference. U.S. banks have asked for regulatory changes which would permit them to write-off more loans but have been rejected. The Bradley proposal recognizes this problem by suggesting a regulatory review board to consider changes in bank regulations and interpretation of accounting rules.

The Bradley proposal asks the commercial banks to take steps which are clearly not in their current interest, in order to gain the possible restoration of LDC creditworthiness. As William R. Cline has pointed out, "[i]t is unlikely that banks would voluntarily forgive the amounts in question, because there would be little reason for them to expect the increased probability of repayment of the remainder to outweigh the direct losses . . ." [36] Stuart K. Tucker of the Overseas Development Council has further suggested, "it is not in the interest of the commercial banks to seek a fair distribution of the costs of the debt crisis. Their concern quite naturally is for their own profits and exposure." [37] Finally, Cline has also pointed out that the "Bradley proposal glosses over an important detail: There would seem to be no legal mechanism that could force banks to relingquish claims." [38] Thus, it is unlikely that the banks would cooperate voluntarily with the Bradley proposal.

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[34] Figures for total bank loans to the Baker Plan Fifteen are for March 1986 and are derived from the Bank for International Settlements, International Banking Developments, First Quarter 1986, Table 4a. Figures for U.S. bank holdings of loans to the Baker Plan Fifteen and for their primary capital are derived from Federal Finnacial Institutions Examination Council, Country Exposure Lending Survey, March 1986, table I and the note on the final page of the survey.

[35] Rowen, Hobart. Bardley Challenges Baker on Third World Debt. Washington Post, July 6, 1986. K 1, K5.

A major difficulty of the current system of debt negotiation is that it is cumbersome. Each debtor country negotiates its debt rescheduling and additional financing with a bank advisory committee, usually representing several hundred banks. Maintaining bank unity has been tedious and time-consuming, resulting in protracted debt negotiations. Negotiations on bilateral government loans have been conducted within the Paris Club of creditor nations. Senator Bradley's proposed summit would apparently be a substitute for these mechanisms. Banks and governments would have equal representation at the summit, "with at least three representatives each to ensure some diversity of view." The proposed summit might be even more cumbersome than existing mechanisms.

Finally, the debtor nations have frequently resented the policy intervention of the IMF and other creditors. The Bradley proposal requires that the amount of debt relief be negotiated annually over a three-year period. This would appear to keep the debtor nations on a very "short leash," an impression confirmed by Sen. Bradley's recent statement that the debt relief "should vary from year to year, and from country to country, depending on results." [39] The debtor nations would be likely to resist this aspect of the Bradley proposal.

### *The Kenen Proposal* [40]

In the spring of 1983, Peter B. Kenen of Princeton University proposed the establishment of an International Debt Discount Corporation (IDDC) by the governments of the industrial nations either as an independent entity or within the IMF. The capital of the IDDC would be subscribed in dollars by the creditor nations and could be either paid-in or callable, but would be large in relation to the organization's liabilities. In return for its own liabilities, the IDDC would discount bank claims on the debtor nations at the rate of 10 percent. Only government or government-guaranteed claims would be accepted for discounting. Participation by the banks would be optional, but participating banks would be required to discount a uniform fraction of all participating LDC debt which they hold. Participating LDCs would have to have a stand-by arrangement with the IMF.

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[36] Cline, Bradley's Debt Plan Won't Work, p. A19.

[37] Tucker, Statement,

[38] Ibid.

[39] Rowen, Hobart. Bradley Stresses Flexibility in Debt Plan. Washington Post, July 25, 1986. p. C8, C10.

[40] Kenen, Peter B. Outline of a Proposal for an International Debt Discount Corporation, May 3, 1983, 3 p. Note available from Peter B. Kenen at Princeton University, International Finance Section.

The bonds issued by the IDDC would be amortized over fifteen years, beginning five years after issuance. The bonds would carry a rate of interest of one percent above the long-term rate on U.S. Government securities. This rate might float partially by being linking to a selected short-term rate such as LIBOR.[41] The bonds would be marketable in a secondary market which is to be developed by the IDDC.

Finally, the claims discounted by the IDDC would be stretched out into long-term debt. They would be amortized over 15 years, beginning after a three-year grace period. The newly rescheduled debt would bear an interest rate no more than a quarter of a percent above the rate on the bonds issued by the IDDC.

### *Analysis of the Kenen Proposal*

Like several other proposals which are examined here, this is a proposal for a one-time stretch-out of LDC debt. The newly created IDDC would become the holder of a percentage of the banks' claims on participating debtor nations. These claims would be rescheduled over 15 years, with a three-year grace period. The interest rate charged by the IDDC would not exceed one-quarter of one percent above the issuance rate on IDDC bonds, thus providing an opportunity for interest rate relief. In return for an easing of the terms on some of their outstanding debt, the debtor nations must have an IMF standby.

The banks stand to gain from this proposal by the off-loading of their LDC debt risks and the re-liquification of their portfolio. A secondary market would allow them to redeploy their assets. On the other hand, the cost would be quite great: an up-front loss of ten percent would be quite large. Over time, this cost would, of course, be offset partially by income earned on the holding of IDDC bonds or on alternative assets if the bonds were sold in the secondary market.

Much of the costs and risks of this proposal would be vested in the IDDC itself and, hence, ultimately passed on to the creditor nations. The direct budgetary costs would be likely to be minimal: Kenen proposes that the capital of the IDDC be callable, although it "might be desirable" for some fraction of it to be paid-in. The proposal also, however, entails the possibility of a unanticipated mismatch of interest income and interest expense which would have to be made up either through a call on capital or through borrowing on international capital markets. Kenen suggests that the capital of the IDDC be fairly large in relation to its liabilities. This would make the IDDC an attractive borrower.

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[41] LIBOR is the London Interbank Offered Rate, the benchmark rate at which banks in London are prepared to lend to high quality banks in the interbank market. The interest rates on international loans are usually expressed as a markup, or spread, over LIBOR.

### THE SCHUMER PROPOSAL [42]

Representative Charles E. Schumer has proposed that interest payments on LDC debt be reduced to sustainable levels. He has suggested that they be reduced to a level equal to 25 percent of a country's annual export earnings, although he considers this to be an illustrative figure. A higher or lower percentage might be appropriate. In addition, he has proposed that the Federal Reserve determine the amount of value-impaired or non-performing Third World debt being carried on the books of commercial banks at face value. The Federal Reserve would then devise a means of "reducing the face value or maturity of the debt to an amount which approximates its fair value and in a manner consistent with ensuring the overall stability of the United States financial sector."

*Analysis of the Schumer Proposal*

The Schumer proposal and the Bradley proposal share the belief that the strategy of dealing with the debt crisis by extending new loans is "fundamentally flawed." It piles more debt on existing debt, thereby aggravating the existing debt problem. In Schumer's words:

> New lending, be it commercial bank lending or balance-of-payments and non-project lending from the international financial institutions, succeeds only in an extremely limited sense: it allows countries to repay old loans. At the same time, however, new loans pile atop old restructured loans to bloat debt service burdens.
>
> Few resources have been left over for development. As a result, the debtor countries have suffered through what has been termed a 'lost decade of growth.' Standards of living have plummeted to levels seen 10 years ago. Poverty and malnutrition have soared . . . Political discontent has arisen.[43]

Representative Schumer, therefore, proposes that debt service be limited to a country's ability to pay, using the ratio of debt service to exports as an indicator of that ability. Proposals to cap interest payments are not unusual. Peru, Nigeria, and Brazil have unilaterally announced such a cap. The difficulty in implementing a cap proposal on an across-the-board basis is that an appropriate rate for one country might not be the appropriate rate for another. Countries differ in their capacity to service debt. Interest payments equal to 25 percent of exports may be a manageable debt burden for one country but not for another.

Representative Schumer also proposes a write-down of value-impaired or non-performing LDC debt. A loan is "non-performing" when interest is 90 days or more overdue. This classification is non-judgmental. On the other hand, loans to a given country are "value-impaired" when the Interagency Country Exposure Review

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[42] U.S. Congress. House. Committee on Banking, Finance and Urban Affairs. International Debt, Trade, and Financial Stabilization Act; report together with additional, supplementary, minority, and dissenting views, to accompany H.R. 4574. 99th Congress, 2d Session. May 6, 1986. Washington, U.S. Govt. Printing Off., 1986, p. 45-46. Report no. 99-577, Part 1.

[43] Ibid., p. 45.

Committee (comprised of the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation) decides to classify them as "value-impaired." This classification is to a large extent judgmental; it is not determined by any absolute standard. At present the loans of six countries are classified as value impaired: Bolivia, Nicaragua, Peru, Poland, Sudan, and Zaire. Thus, the Schumer proposal is asking the Federal Reserve to determine which loans should be written down, a judgment it now shares with other agencies.

The Federal Reserve is also asked to determine by how much loans should be written down and in what manner. Loans are to be written down to "true value," which is to be determined by the Federal Reserve. The Schumer proposal provides no guidance in defining "true value". The "true" value could perhaps be considered the market value; there is a small secondary market in Third World debt. The proposal does not, however, suggest this alternative. In any case, any definition of "true value" is likely to be disputed on methodological grounds, especially since the loss of large sums of money is involved. Finally, Representative Schumer also suggests shortening loan maturities, a proposal which would actually increase the debt burden.

Managing a major write-down "in a manner consistent with ensuring the overall stability of the United States financial sector" is a difficult management and technical problem. It may prove insurmountable or require that U.S. taxpayers bear a substantial share of the cost of such a write-down.

Finally, most economists consider that the international debt problem was, in part, brought on by the poor economic management of the LDCs. The Schumer proposal makes no provision for ensuring that the LDCs undertake needed economic reforms. Without such reforms, the debt relief provided by the Schumer proposal might not solve the debt problem.

## Debt Repudiation: The Castro Proposal

On the spectrum of solutions to the debt problem, debt repudiation or default is the most radical. The banks sustain a total loss, and the debtors receive total relief.

### THE CASTRO PROPOSAL [44]

Fidel Castro's proposal is strikingly simple: cancellation or repudiation of the debt. Castro further suggests that the cost of cancellation of the bank debt be taken over by the creditor governments which could use a "small percent of military expenditures—which couldn't be more than 12 percent" to assume the debt owed to their banks.[45]

Castro is concerned with the transfer of resources out of Latin America:

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[44] Castro, Fidel. There's No Other Choice: the Cancellation of the Debt or the Political Death of the Democratic Processes in Latin America. Economic Section of the interview granted to Representative Mervyn Dymally and Prof. Jeffrey Elliot of the United States, March 29, 1985. Impreso en el palacio de las convenciones, La Habana, Cuba, 1985, 53 p.

[45] Ibid., p. 18.

> [I]n just one year, 1984, Latin America transferred economic resources worth more than $70 billion to the industrialized countries, as follows: interest on the debt and profits, $37.3 billion; deterioration in the terms of trade, $20 billion . . . $10 billion for the flight of foreign currency. . . . And lastly, . . . $5 billion due to the overvaluation of the dollar.[46]

Castro further argues that much of this transfer was "illegitimate."

Castro believes that the governments of the debtor nations can no longer force sacrifices of the extent required upon their populaces and, more importantly, that the initiative has shifted to the debtor nations:

> Essentially the situation is as follows: it is materially impossible to pay the debt and its interest; therefore, . . . the debt cannot be paid. It would take rivers of blood to force the people to make the sacrifices this would imply—for which they would receive nothing. No government would be strong enough to do this. This is worth analyzing, discussing and solving in common agreement between creditors and debtors. We should never forget, even for an instant, that the initiative has passed to the nations that are being pressured to make this monstrous sacrifice.
>
> If the debtor countries of the Third World are forced to decree a suspension of payments unilaterally, the industrialized countries will be left without any possible alternative for action. An economic blockade; an invasion of the Third World; a new repartition of the world, as in past centuries, in order to guarantee raw materials and markets or to collect the debt is simply impossible.[47]

Finally, Castro points out that cancellation of the debt would even help some interests:

> [I]t would even help the foreign companies with investment in those countries, the companies that have trade relations with those countries, the companies that produce goods for those countries. And, in the creditor countries, the state wouldn't be hurt economically. To the contrary, they would raise their levels of employment and use of industrial capacity; their banks wouldn't have any losses; and their taxpayers wouldn't have to pay any more taxes.[48]

### ANALYSIS OF THE CASTRO PROPOSAL

Possibly more than any other proposal which has been considered in this paper, the Castro proposal is based on a political analysis of the debt problem. One of the more important issues which Castro raises is whether or not the initiative in the debt crisis has shifted to the borrowers. Recently, Anatole Kaletsky suggested using a "vulnerability ratio" to assess a country's vulnerability to default.[49] The vulnerability ratio is the ratio of interest payments to new borrowings. When interest paid exceeds the amount of new money received, that is, when there is a net financial outflow, the incentive to maintain debt payments decreases and the incentive to default increases. The higher the ratio, the greater the incentive to default. Vulnerability ratios in 1982 and 1985 for the Baker Plan Fifteen as a group are shown in table 1. Between 1982 and 1985, the vulnerability ratio for these fifteen countries as a group rose from 1.7 to 5.1, tending to confirm Castro's suggestion that the initiative has shifted to the debtor countries.[50] This increase in the vulnerability ratio resulted both from a decline in new money and an increase in interest payments.

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[46] Ibid., p. 2.
[47] Ibid., p. 38–39.
[48] Ibid., p. 37–38.

TABLE 1.—VULNERABILITY RATIOS: "BAKER PLAN" 15, 1982 AND 1985

[Dollar amounts in billions]

| Country | 1982 |  | 1985 |  |
|---|---|---|---|---|
|  | Interest | New money | Interest | New money |
| Argentina | $1.2 | $-0.8 | $5.2 | $2.9 |
| Bolivia | .2 | -.2 | .3 | -.1 |
| Brazil | 9.3 | 6.5 | 11.6 | .0 |
| Chile | 1.9 | .9 | 2.1 | .7 |
| Colombia | .7 | .7 | 1.1 | -.6 |
| Ecuador | .6 | -.1 | .8 | .2 |
| Ivory Coast | .5 | .2 | .5 | .3 |
| Mexico | 6.0 | 3.5 | 10.0 | 2.7 |
| Morocco | .6 | .3 | .9 | .4 |
| Nigeria | .8 | 2.3 | 1.1 | 1.0 |
| Peru | .5 | .9 | 1.1 | -.1 |
| Philippines | .9 | 1.1 | 2.3 | -.4 |
| Uruguay | .1 | .3 | .4 | -.1 |
| Venezuela | 1.6 | .4 | 3.5 | .6 |
| Yugoslavia | 1.6 | -.6 | 1.6 | .7 |
| Total [1] | 26.5 | 15.3 | 42.5 | 8.3 |
| Weighted ratio for group |  | 1.7 |  | 5.1 |

[1] Totals may vary due to rounding.

Sources: Bank for International Settlements, International Banking Developments, Third Quarter 1984 and First Quarter 1986; World Bank, World Debt Tables, 1984-1985 ed., and unpublished U.S. Treasury data.

The desirability of default is not just a simple statistical calculation:

> The penalties for default are inherently uncertain. Penalties, after all, are likely to be largely political in nature, and attempts to quantify them are almost certain to be misleading. . . . The outcome will depend largely on how the governments of creditor countries respond to default.

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[49] Kaletsky, Anatole. The Costs of Default. Twentieth Century Fund, Priority Press Publications, New York, 1985. p. 102-103. In addition to adapting Kaletsky's "vulnerability ratio," the analysis of the Castro proposal contained in this paper frequently draws on the insights provided in the Kaletsky book. Readers interested in a fuller treatment of the issue of default are directed to Kaletsky's work.

[50] Some of the increase in the vulnerability may possibly be explained by the need to use two different sources for the data on interest payments. Interest figures obtained from the U.S. Treasury for the year 1985 may be more complex than the figures used for 1982, which were derived from the World Bank Debt Tables, 1984-1985 ed. Nevertheless, the Baker Plan Fifteen now appear to have a greater propensity to default than in 1982.

> Potential defaulters are unlikely to try to quantify the costs of defaulting by attaching more or less arbitrary numerical probabilities to risk of an all-out economic war with the governments of industrial countries. If a political leader feels that he may be ousted if he does not take drastic action, he will not bother much about refined hypthetical calculations about the long-term costs of default—he will try to assess the likelihood of catastrophic retaliation and hold this up against the possible gains from default.[51]

In the end, the decision to default is to a large extent a political decision as well as an economic decision. The issue is the willingness to pay, not the ability to pay. In the past, defaults have occurred at different levels of debt burden both for the same country and for different countries.

Castro highlights another important issue: the issue of creditor remedies in the event of default. Historically, actions taken against defaulting debtors have sometimes been quite vigorous, including such steps as taking over customs collections and even blockades. Such drastic remedies, however, are no longer politically possible. The remedies available are now much more limited.[52] Assets used for governmental purposes cannot legally be seized. Central bank reserves are largely kept with the Federal Reserve Bank of New York and are, therefore, largely unavailable to private banks for offset proposes.[53] State corporations are separate legal entities, responsible only for their own debt. Private corporations and individual citizens are not liable for the debt of their government. Contractual arrangements regarding the passage of title may limit the potential for seizing exports. Finally, the broader goals of the banks themselves may limit their willingness to resort to legal remedies. They may, for example, have branches in the defaulting country. Finally, the extent to which remedies are used is likely to depend on the nature of the default, that is, the extent to which it is conciliatory versus confrontational.

The loss of credit would be the strongest sanction against default, but even this would have limitations. History indicates that the loss of medium-term credit is not forever. All of the Latin American countries now experiencing difficulties defaulted in the 1930s. After about thirty years they were able to resume borrowing. Even Cuba, one of the few countries to openly repudiate its debt, was able to resume small amounts of borrowing within a decade.[54]

The loss of trade finance, however, would be likely to be more serious than the loss of medium-term credit. Nearly all trade is financed in some way; very little trade is on a cash-and-carry basis or on open account. While the loss of medium-term credit would be a one-time occurrence, the loss of trade finance would be an ongoing problem. But even the impact of the loss of trade finance could be mitigated. The increased availability of foreign exchange resulting from a default would mean a greater ability to purchase imports for cash. Some suppliers' credits might not be interrupted. Bartering would be an option, albeit somewhat limited. Lastly, the banks' own customers might push for the resumption of finance for their exports.

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[51] Kaletsky, p. 18.

[52] The arguments regarding remedies for default rely on Kaletsky, Chapter 4 and 5. A summary of Kaletsky's view is contained in Kaletsky, Anatole. Banks and Latin American Debt: Seizing Assets is not so Easy. Financial Times, June 25, 1984. p. 15. For a contrary view, see Enders, Thomas O. and Richard P. Mattione. Latin America: The Crisis of Debt and Growth, Washington, D.C., The Brookings Institution, 1984, p. 47-50.

[53] Foreign central bank reserves are covered, in the United States, by the Foreign Sovereign Immunities Act (28 USC 1611b1) and, in the United Kingdom, by the State Immunity Act of 1978.

[54] Kaletsky, p. 18. See also footnote #2 on p. 88 in the same source. Currently, Cuba has recently rescheduled its debt with official creditors and is negotiating a rescheduling of its bank credits, on whose debt service it has now fallen behind.

Finally, as Castro suggests, not all interests in the creditor countries would be equally affected by a default.[55] The removal of foreign exchange constraints and the possibility of increased economic growth would benefit multinational corporations doing business in or with the defaulting debtors. Exporters, including farm interests, and their employees might stand to benefit. Companies competing with Third World producers might face less competition. Indeed, the trade accounts of the creditor nations might be under substantially less pressure after a default. The major banks however, would be dramatically affected. In March 1986, the nine major U.S. banks had loans outstanding to the fifteen proposed participants in the Baker Plan [56] equal to 133.3 percent of their capital. In the event of a widespread default, these banks might be insolvent.

## CONCLUSION

The international debt problem has had a major impact on the Third World and on the United States. The adverse impact of the debt problem is likely to continue unless steps are taken to ameliorate its effects. This paper has examined a wide variety of proposals for solving the problem. Major characteristics of the proposals are summarized in the matrix on page 3. Nine of the proposals, the majority, recommend limiting debt service. The Bradley, Kenen, and Schumer proposals also provide for write-downs of principal. Three proposals, most notably, the Baker Plan, are based largely on the provision of new finance.

Nearly all of the proposals are quite comprehensive. A few, such as the Economist's proposal for a secondary market in Third World debt and an interest rate CFF, are more limited, providing for only a whittling away at one or more specific aspects of the problem. Examination of all of the proposals, however, strongly suggests the extreme complexity of the international debt problem. The development of a satisfactory comprehensive solution to the problem is, therefore, likely to be difficult.

The most difficult issue in developing a solution to the Third World debt problem is the allocation of costs. Ultimately, the allocation of costs is a political decision. Thus, a new approach to the debt crisis awaits the emergency of a new political consensus.

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[55] The differential impact of the debt problem is also discussed, for example, in a staff study prepared for the Joint Economic Committee of the U.S. Congress, "The Impact of the Latin American Debt Crisis on the U.S. Economy."

[56] The fifteen countries had loans outstanding to the nine money center banks equal to $58.1 billion. The total capital of the nine money center banks amounted to $43.6 billion.

# NEW APPROACHES TO BANK LENDING TO DEBTOR COUNTRIES*

By William R. Cline

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## STATUS OF THE DEBT PROBLEM

There is a broad public impression that the current strategy for managing the debt problem has collapsed. Mexico's problems after the oil price fall in 1986 and Brazil's recent suspension of interest payments are cited as cases in point. Yet a closer look at developments over recent years suggests that temporary setbacks such as these are low points in cyclical fluctuations around what has been a general trend of improvement in the overall performance of the debtor nations.

The best single measure of debt burden is the ratio of interest burden to exports of goods and services. This indicator shows that the non-oil Latin American countries have made considerable progress; they have reduced the ratio from 47 percent in 1982 to 34 percent in 1986. The oil countries had also made modest improvements until the collapse of oil prices in 1986, and with the partial recovery of oil prices this year, their position should improve again. In particular, the ratio of interest payments to exports in Mexico, which stood at 38 percent last year, should be down to around 27 percent this year.

There have been major achievements in adjustment in the debtor countries. Sharp cutbacks in current account deficits, major reductions in fiscal deficits, and large real devaluations of exchange rates to stimulate exports have been achieved. By 1984, domestic economic growth was reestablished for many of the debtor nations. Following negative growth averaging 1.7 percent annually in 1981–83, growth in the non-oil Latin American countries rose to 3.5 percent annually in 1984-85, and then to 6.5 percent in 1986. The oil-

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*Summary of *Mobilizing Bank Lending to Debtor Countries* (Washington: Institute for International Economics, Policy Analyses in International Economics, No. 18.), June 1987.

exporting Latin American countries suffered a setback in growth in 1986 from the oil price collapse, but a recovery is expected this year.

Despite being hard hit by the collapse of oil last year, Mexico has been a success story, achieving a dramatic external-sector recovery. Mexico increased its non-oil exports by 40 percent in 1986. A progam of tight domestic monetary policy coupled with an aggressive devaluation turned a net capital outflow into an inflow, a reversal of about 3 billion dollars annually. Today, Mexico's reserves stand at an impressive $13 billion and the country is likely to run a current account surplus of approximately $2 billion for this year.

The main point to recognize about Brazil's current economic problem at the moment is that it was not caused by an international economic shock beyond the country's control, but rather, was the cosequence of domestic economic mismanagement. Overheating of the domestic economy and distortions under last year's price freeze caused a collapse in exports and, therefore, the trade surplus. There are, nontheless, encouraging signs that the Brazilian economy can quickly turn around. On June 12, the government announced a new adjustment package containing serious new measures to cut fiscal deficits, devalue the exchange rate, and freeze prices for a 90-day period to halt near-hyperinflation. These measures make it highly likely that the trade surplus will rise again, hitting perhaps $7 billion this year. The new program may also provide the basis for a rapprochement with the banks and the International Monetary Fund.

In general, for the large debtor countries, one cannot make the case that the debt problem is one of "insolvency" that requires concessional forgiveness of debt or interest. On the contrary, these countries have sound economic prospects over the longer term.

The manageability of external debt will depend heavily on international economic conditions. Continued growth in the industrial countries is an important condition for the debtor nations to achieve progress. A minimum threshold of 2 to 2.5 percent growth in the industrial countries is essential, and seems likely to be achieved. This growth threshold can be lower now than the 3 percent rate that was often cited in previous years, because international interest rates are down from around 12 percent to 7 percent

Commodity prices have been a disappointment so far, but the beginning of an upward trend may now be discerned. An index of 10 commodities important to developing countries weighted by the share of each commodity in LDC exports (excluding oil) rose by six percent from January to June of this year. If coffee is excluded from this measure, the index is up by 22 percent from the mid-1986 trough. Indeed, what is beginning to happen is the arrival of the expected rise in the dollar price of commodities associated with a decline in the real value of the dollar since February 1985. As for oil, the 1986 shock certainly hurt oil-exporting debtor countries such as Mexico and Venezuela, but the recovery of prices to $18 per barrel or more substantially improves the prospects for these countries without inflicting a serious blow on the oil-importing debtor countries.

Greater official financial support is needed in the management of the debt problem. The new money called for by the Baker Plan is probably not sufficient in this process and the bulk of extra funds should come primarily from public sector sources such as the World Bank. Expanded lending from the national export credit agencies should be a key vehicle. This approach would harness in a positive way the congressional concern about the plight of US exporters and manufacturers and their workers who have been hit by decreased exports because of the debt crisis. John Bohn of the Export/Import Bank has recently proposed a very constructive program of at least one billion dollars a year of export credits in 25-year loans to the debtor countries, to be matched by a similar program in Europe and Japan. Such a program deserves support and expansion.

## CONCESSIONAL DEBT RELIEF

There have been recurrent calls for the banks to forgive part of the debt owed by developing countries. However, concessional debt relief is incompatible with improving the debtor countries' creditworthiness and, therefore, with returning the debtor countries to a close relation with the international capital markets on a voluntary lending basis for full integration into the international economy. The debtor country's own growth is likely to suffer from debt forgiveness, as it is isolated from credit and trade markets, which tend to go hand-in-hand. In contrast, another reason why concessional debt relief has been opposed—the risk of a collapse of the banking system—is becoming less of a central concern, as US banks are not only building up capital but also are now setting aside loan loss reserves.

A quantitative investigation of the plan of Senator Bill Bradley (D-NJ) and other such plans for concessional debt relief shows that the cost-benefit ratios of such initiatives are doubtful. In the case of Mexico, calculations show that the Bradley Plan, which would forgive three percent of debt and three percent of interest over a three-year period, would ease Mexico's foreign exchange constraint to provide a one-time increase in imports of about ten percent, permitting a one-time increase in its GNP of around one percent. Although this gain is much more modest than advocates of concessional debt relief seem to expect, the calculation does not include the negative long-term effects of damage of the credit relationship with the banks.

An alternative approach suggested by Congressman John LaFalce (D-NY) proposes the creation of a new entity that would buy up the debt at a discount based on the secondary market value and convey that discount to the country. The problem with the LaFalce approach, which could actually convey substantially more debt relief than the Bradley plan, is that if it is on a voluntary basis few banks will sign up and not much debt will be affected. If the program is on an involuntary basis, it does damage to the credit relationship between the country and the banks into the indefinite future as outlined above.

In short, programs for concessional relief appear inappropriate and probably counterproductive for the large debtors that owe the bulk of the debt to commercial banks. Concessional relief may be more appropriate for some of the poorest countries with debt primarily from official sources (particularly in Sub-Saharan Africa).

## REINFORCING THE BAKER PLAN: NEW MECHANISMS FOR MOBILIZING BANK LENDING

Given the premises outlined above—that there continues to be a general trend of improvement in the performance of most of the debtor nations and that programs of concessional relief are generally ill-advised—what is needed is a reinforcement of the Baker Plan strategy through firmer mechanisms for mobilizing new lending by banks.

The Baker plan set a target for new bank lending of 2.5 percent annual growth in the outstanding loans of banks to the 15 largest debtor countries over the next three years. Multilateral development banks were to double their net disbursements to these countries. The debtor countries would commit themselves in turn, to substantial programs of adjustment. The multilateral agencies and the debtor countries have successfully met their part of the formula but the commercial banks have not.

Data available from the Bank for International Settlements and the Federal Reserve suggest that the commercial banks have not only not met the 2.5 percent growth commitment, but actually cut their exposure to the 15 Baker countries. US banks, in particular, reduced their exposure by ten percent from December 1984 to December 1986, while total industrial country bank exposure was down by one percent. It should be noted that these data are somewhat deceptive because, first, they include some countries in near-default such as Peru and Bolivia, where the banks have written down a significant portion of their loans. Second, some of the largest debtors were not asking for new money because of their strong trade results in 1984–85, and therefore the banks shall not be held accountable for failing to lend new money to them. Despite these caveats, commercial bank lending performance to date is disappointing.

The 1987 figures for new lending will almost certainly look much better than those through 1986, as completed or nearly completed new money packages of $7 billion for Mexico, $2 billion for Argentina, and a probable $3 billion for Brazil come into place.

Further evidence that a problem nonetheless needs to be addressed is provided by the experience of the Mexico package. The major creditor banks signed onto the package in September of 1986 and the first disbursements were to occur by December. Yet the first actual disbursements did not occur until the end of April, after months of efforts to round up support by the banks. Even then, 139 of the 500 banks supported to participate refused to do so. These events led to a widespread concern that the new-money process was breaking down.

A new approach to the lending process is needed to raise the level of bank lending and to cut down the amount of time it takes to put together a financial package. A "menu" of new lending options that are tailored to the diagnoses and needs of individual banks could make a major contribution. The overall target of new lending that needs to be mobilized is something like the Baker

Plan's target: 2.5 percent expansion of claims annually, or the equivalent of about one-third of the interest that is due. This target could usefully be placed at up to one-half of the interest due. From financing more than the entirety of the interest due prior to 1982, the new lending pendulum swung to financing virtually none in the 1984–86 period. The pendulum needs to shift part way back again, to the re-financing of at least one-third of the interest as suggested in the Baker Plan.

There is a new concern that the decision by Citibank, followed by that of most large U.S. banks, to set aside $3 billion of loan-loss reserves, will kill the Baker plan and put an end to bank lending. There is a natural initial logic that reasons that if the banks are in effect stating that the old money is no good, why would they lend any more? Furthermore, will this action not give the regional banks an easy excuse to refuse participating in lending?

What must be considered is that the banks still have a large stake outstanding in the debtor countries, and therefore an incentive to secure that stake. European banks, which have had loan-loss reserves all along, have continued to participate in new money packages. Early evidence of the commitment of nearly 90 percent of the new money for Argentina by late June, following the Citibank decision in May, would seem to indicate that the large banks are going out of their way to act promptly to demonstrate they are not abandoning the debt management process. The Citibank action, consequently, does not fundamentally change the structure of the incentives and the nature of the issue.

In some dimensions, the action is beneficial. By imposing discipline on future dividends (through the reduction of shareholder equity on the books), the shift of funds to loan-loss reserve strengthens the banking system. It facilitates a determined negotiating position when banks seek a strong country economic program as a precondition for new lending. And it allows greater flexibility to the banks for adopting many of the options that would be available in a "menu" approach, such as conversion of debt to equity at a discount.

### *Conceptual Framework*

For the major debtor countries it is desirable for all parties to provide modest additional lending to permit continued adjustment and restoration of creditworthiness. The calculation from the banks' standpoint is that the benefit of additional lending is equal to the reduction in the probability of default multiplied by existing debt. The costs of new lending, on the other hand, equal the value of the new loans multiplied by the remaining probability of default. In the major cases the benefit of additional lending continues to exceed the cost.

Two main types of problems arise in the process of trying to mobilize bank lending: a) there is disagreement among banks on whether a country is indeed able to recover; and b) there are attempts by some banks to be "free riders", that is, to benefit from loans by others without contributing themselves.

The premise of the menu approach is that all banks can be divided into three classes and that a variety of options should be tailored to each class.

Type A banks are those that believe that the debtor country involved in a particular lending program is not insolvent and can therefore service its debt on a commercial basis over the long term. For these banks the proper action is precisely the process of new lending under the Baker plan. The menu approach seeks to offer new vehicles that would make the process of lending by these banks more attractive.

Class B banks have a sharply different diagnosis. They see the debtor country as basically insolvent and therefore unable to service its debts over time. Class B banks should be prepared to exit from the new lending process at the price of a benefit conveyed to the country through a discount from the face value of the debt in order to avoid further losses in the future.

Class C banks are the free riders.

The objective of the menu approach is to move banks out of class C into either class A or class B, but to ensure that all of the banks except for a very small fringe of de-minimis banks clearly participate in one form or the other: either through providing new money, or through exit at a price.

Some banks, which claim essentially that they are in class B, argue that they should not convey any relief to the country unless all of the other banks do so as well. This position is not tenable, and amounts to an excuse for free riding. If the banks truly think that the diagnosis for the country is as bad as they say, then they should be happy to get out now, at a lesser loss, rather than contributing new money like the other banks and, by their own argument, sustaining a far greater loss in the future.

It is important to note that the proposed class A/class B approach and the corresponding alternative menu options implicitly lay the groundwork for future concessional relief should things turn out badly. Essentially, under unfavorable future scenarios of country recovery, over time more and more banks would change their diagnosis from class A to class B identification. The shifting center of gravity would de factor mean rising concessional relief. The approach outlined here is thus quite flexible.

### *A Menu of Options*

*Bonds.*—The primary option proposed here for class A banks is that they make the form of their new money the purchase of bonds from the country. Bonds, which have generally not been rescheduled in the past, would provide a form of preferred status, or seniority, for the new money of class A banks. This preferred status would make the new claims attractive and maximize the likelihood that banks would be willing to acquire them. Moreover, in the future as the country reestablishes creditworthiness, banks could sell off the bonds into the general capital market, thereby diversifying the sources of capital to the country and further reducing the risk to the banking system. The bonds would be issued in bearer form. The eventual wider dispersion of the bonds, and their untraceable nature, would tend to reinforce the exemption from rescheduling.

The terms of the bonds would have to be consistent with economic reality. Maturities would have to be a minimum of five years, or preferably ten years, to give the country time to make economic progress and to be in a position to amortize the bonds.

The alternative method of formally granting the new money senior status would require reopening all past loans and incorporating subordination clauses, which would in practice present a legal nightmare. Seniority can be accomplished de facto by the purchase of bonds as the form of new money.

Co-financing with the World Bank is another alternative that would confer some degree of seniority. Co-financing comes in basically two forms: vanilla and raspberry. The plain kind provides little real assurance by the World Bank, which merely provides parallel lending. This type is probably moderately helpful. The raspberry version is much stronger and comes in the form of "B-loans" that are actually a part of a joint syndication with the banks. The World Bank must share earnings with the banks if the country misses payments to them. This "strong" kind of co-financing is probably too much to ask of the World Bank because it essentially extends the institution's exposure to cover not only its own loans—which are already growing in their share of new lending—but also the bulk of new bank lending. Stronger versions of seniority will have to be created by the banks themselves, through the purchase of bonds or other mechanisms.

The bond approach would be economically credible because the magnitude of the new lending would be sufficiently small relative to the outstanding stock of the bank claims that bonds would remain a small fraction of the total, and could, therefore, credibly come at the head of the queue. Specifically, at the Baker 2.5 percent annual rate of increase, even if all of the new money would be put into bonds, they would amount to only six percent of the outstanding claims of the banks at the end of three years.

The Argentine package adopted in April set a precedent for bond sales, but provided too small a role for these instruments by limiting each bank to a maximum $1 million purchase. The proposal presented here would radically upgrade the role of bonds, making them the main vehicle for mobilizing lending in new money packages to accomplish the seniority objective.

*Voluntary Interest Capitalization.*—The second major item in the menu is voluntary interest capitalization. Interest capitalization means that instead of making a new loan, the bank allows the country not to pay currently a fraction of the interest that it owes the bank, but instead simply add it onto the outstanding amount. The principal objective of the interest capitalization option is to make sure that every bank, whether class B or class A, has an assured vehicle for participation. Voluntary interest capitalization allows those banks unwilling to participate with direct loans or bond purchases to provide a form of new lending without having to take the loans before their boards of directors, for example, and without having to put them on their books. In Europe where new loan-loss reserves are required for new lending, interest capitalization provides a way of increasing a claim without setting aside loan-loss reserves, if the amount is not placed on books as an asset.

It is desirable to limit interest capitalization to a minor share of the new lending, perhaps a 15 to 20 percent maximum, because there are some systemic risks involved. If a much larger share of new money took the form of interest capitalization, it would become a mainstream approach, and at that point there would be a growing temptation for the country to move toward unilateral declaration of the fraction of interest to be capitalized.

*De-Minimis Rule.*—The negotiating process could be streamlined by having a de-minimis rule that stated that those banks that accounted for the last five percent of exposure would simply be exempted from new money obligations. The consequent increase in burden for the rest of the banks would be minimal.

Some might say that defining a cutoff line might create problems for borderline banks. But this concern is unfounded; a small bank that was above the line in one country could well be below it in another; and in any event, any exemption at all is a windfall gain.

The importance of the de-minimis rule is not only that it would streamline negotiations, but also that by defining who is out the rule would define who is in. All other banks above the cutoff point would definitively be expected to participate either through class A or class B options. The larger banks could no longer refuse to participate on grounds that there was not 100 percent participation. In the case of Mexico, for example, this process would cut out some 230 banks from the list, vastly reducing the number of parties that would need to agree to future money packages. The de-minimis rule also avoids inequitable distribution of overhead costs. Thus, in the case of Argentina, the last 100 banks (accounting for only 1 percent of total exposure) would lend only $80,000 annually by the Baker formula. Yet such banks would exhaust any possible profit from the new loans with just three man-days of a $60,000-a-year executive's time.

*Equity Conversion, on Lending.*—The remaining class A options would include conversion of debt to equity, on-lending to the banks' private sector clients, and contingency lending. Banks would find it more attractive if their new lending could be converted into equity investments, or channeled directly to their multinational clients in the country.

In both cases the governments must decide how large such programs can be without destablizing the money supply. The answer will vary from country to country. Mexico has a low ratio of money supply to foreign debt and could therefore convert only a limited amount of debt to equity without raising monetary problems; Brazil has a much higher ratio of money to debt and could do more without excessive monetary expansion. The popular impression of large Chilean debt-equity is somewhat misleading, because it is a rather special case driven by the need to rescue a large number of bankrupt domestic companies with foreign takeovers.

Other issues on debt-equity conversion include whether it tends to substitute for the direct foreign investment that would have occurred otherwise, and whether it imposes excessive costs on country governments as they switch from foreign debt to domestic debt with much higher real rates of interest. The Argentine government may have been too rigid based on the first of these concerns by insisting on "matching" fund conversion, whereby each dollar of debt-equity conversion must be matched by an additional dollar of direct foreign investment. As to the concern about switching foreign debt to domestic, the government will benefit as long as the discount is large enough, or if the risk premium on foreign exchange obligation is high. Each country's abilities must be judged separately; the more a country can convert, the more attractive it can make new money to the banks.

Finally, contingency lending such as the oil price provisions included in the Mexico package are a promising development. However, they must be symmetrical so that banks can reduce new money commitments if the price of the commodity rises rather than falls, if banks are to find them a useful innovation rather than a new burden.

*Exit.*—Class B options are led by the so called "exit bond". The Argentine package presents a concrete example of its use, but in too small an amount (a $5 million limit per bank). The banks that want to get out of the new money process definitively have the alternative of purchasing an exit bond that pays concessional terms. In the Argentine case, the bond pays only four percent interest and has a 25 year maturity (with 12 years grace). The present discounted value of this instrument is about sixty cents on the dollar, which is roughly equivalent to the discount in the secondary market for Argentine debt. This option thus presents a windfall concessional relief to the country that amounts to about 40 cents on the dollar in exchange for opting out of the new-lending process in the future. The terms on the exit bond should not be too punitive; otherwise the banks will seek instead to dispose of their claims in the secondary market itself, with no relief conveyed to the country. Exit bonds should be made available in much larger amounts, perhaps up to $50 million dollars, so that class B banks of substantial size can meaningfully exit.

Discounted debt-equity conversion provides another class B option. Several countries already have such programs. Under this option the banks convert debt to equity at discount related to that prevailing on the secondary market (30 to 40 percent in most cases). The bank would get equity with a profit potential and the country would get a reduction in debt burden. The bank would then no longer be in the new-money base.

A discounted loan repurchase, whereby the country itself repurchases the loan at a discount is another possibility, but is unusual in that it requires the country to have liquidity. Mexico might be able to repurchase loans given its large reserves, and Bolivia reportedly will be doing so with the aid of some European governments at the rate of some 20 cents on the dollar.

An important question is whether there is equity in terms of comparable effort across the menu options. As it turns out there generally is. If measured in terms of cash flow, an exit bond paying four percent has the same effect as a new money package refinancing half of the interest when the rate is 8 percent. Debt-equity conversion has even more favorable cash flow effects because it extinguishes the debt and therefore the interest payment. However, if one considers the contingent obligation of future profit remittances associated with debt-equity conversion, this instrument becomes more comparable to new money on cash flow terms. Only one instrument is not comparable: the discounted loan repurchase (which causes an immediate negative cash flow), although as has been pointed out, its adoption will be rare given the liquidity required for its implementation.

In a more fundamental sense, the real cost is equal among the options because of the varying diagnoses. To a class B bank, exit at a price is the lowest-cost option; to a class A bank, new lending is the lowest-cost, because is has a more favorable view of the country's future debt servicing capacity.

The functioning of the menu approach can be illustrated by considering a hypothetical future "difficult case,." Suppose there would be 30 percent leakage of new money in such a case through non-participation by many banks. Under the menu approach there would be only a five percent leakage (under the de-minimis rule); the remaining 25 percent that would have leaked moves into class B action—primarily in the form of exit bonds and discounted debt-equity conversion. Class A banks continue to participate but predominantly through bonds. Modest voluntary interest capitalization by both class A and class B banks could occur as well.

*Other Improvements in the Strategy.*—Some other institutional changes could strengthen the lending process as well. Converting floating interest rate obligations into fixed rate obligations may be a beneficial move at this time. Although interest rates have fallen dramatically in the last three years there is the risk of a future rise as inflation heads up from the abnormally low level of 1986. The risks involved in floating rate obligations are substantial. If LIBOR were to rise by five percentage points, the increased debt servicing obligation would amount to 28 percent of imports for Brazil and 48 percent for Argentina.

The market can be used to switch floating rate debt to fixed rate debt. The banks will probably not be able to take on fixed rate claims themselves, but rather could swap into the financial markets. If necessary, the World Bank could act as an intermediary to place the swap into the market. The key element here is to divorce the country risk from the interest risk. In addition, a new compensatory finance facility for interest rate fluctuation should be created in the IMF to complement this process.

The size of spreads should be guided by the rule of reason. The spread of ¹³⁄₁₆ obtained by Mexico is becoming a political imperative for many countries. But the countries should not go too far, as they could kill their chances of returning to voluntary credit markets by pressing the banks into spreads which the latter consider to be highly concessional. One useful instrument would be a performance-related spread, which could begin at 1 and 1/8, for example, and then decline to ⅗, contingent on the country's achieving a specified reduction in the ratio of debt to exports.

On the issue of monitoring, if the country has a sound economic program but faces severe political obstacles to entering into an IMF stand-by program, then the World Bank could act as the monitor instead. The broad point is that the system should not be excessively rigid. Venezuela and Brazil may be candidates, although Brazil seems to be edging toward an IMF program in order to obtain refinancing for the $1 billion annually it now owes to the Fund.

In sum, the basic strategy under the Baker initiative remains alive. The development of a menu approach to revive the bank lending component of the Baker plan would reinforce the strategy. It is better at this point to continue to build on the costly and broadly successful efforts of the countries to date rather than to nullify those efforts by turning to radical solutions.

# FOREIGN TRADE AND INVESTMENT

## DEBT AND DEVELOPMENT IN LATIN AMERICA: THE ROLE OF FOREIGN DIRECT INVESTMENT

By Kristin Hallberg

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### SUMMARY

The burden of external debt in Latin America grew steadily throughout the 1970's and then rose dramatically in 1979–82 with the rapid surge in real interest rates, a world recession which led to falling export prices and volumes for developing countries, and a worsening in the maturity structure of debt. Commercial bank lending, which through the 1970's had accounted for an increasing share of the flow of external financing to Latin America, slowed considerably in 1982, leading to a series of debt service interruptions and reschedulings. Though some economic forecasts predict more manageable levels of debt in the 1980's, developing countries will not be able to rely on commercial banks to supply the requisite amount of external capital to the extent that they did in the past. Increasingly, attention is being paid to the potential role of foreign direct investment to furnish a portion of the region's external financing requirements.

The potential for substitution of equity financing for bank lending does not appear to be large: foreign direct investment is expected to continue to provide less than 20 percent of the region's annual external financing requirements. The more important contribution of foreign direct investment to the alleviation of the debt burden will arise from its potential complementarity with other forms of external capital, and the degree to which it stimulates general economic development.

The degree to which direct investment may promote a more manageable mix of external capital flows, as well as contribute to the general development process, will be strongly influenced by host government policies. Host governments must be receptive to foreign investment; however, experience has shown that multinational enterprises will continue to invest even when host country policies are fairly strict, as long as they believe that the policies will be fairly consistent and stable. And, while foreign investors are concerned about policies directed specifically toward direct investment, their decisions may be even more strongly influenced by the stability and rationality of general macroeconomic policies in the host country.

## PART I. FOREIGN DIRECT INVESTMENT: A SOLUTION TO THE DEBT PROBLEM IN LATIN AMERICA?

> A world with strong foreign investment flows is the opposite of a zero-sum game. We believe there are only winners, no losers, and all participants gain from it . . . foreign direct investment flows which respond to private market forces will lead to more efficient international production and thereby benefit both home and host countries . . . A free and open international investment climate will play a key role . . . in resolving many of the current international debt problems.

—Statement by President Ronald Reagan, September 9, 1983; in U.S. Dept. of Commerce (1984).

### THE BURDEN OF FOREIGN DEBT

Since 1981, Latin America has been facing its worst economic and financial crisis since the depression of the 1930's. The past few years have seen a cessation of economic growth and a sharp rise in unemployment in a region with continued high fertility rates. Hunger threatens large segments of the population, and protests in Sao Paulo, Rio de Janeiro, Santiago, and Lima have demonstrated the political ramifications of the crisis. The primary cause of this recent economic upheaval has been the burden of servicing large levels of foreign debt that grew throughout the 1970's and became unmanageable in the 1980s.

At the end of 1983, Latin America's total external debt was about $336 billion, compared to $75 billion in 1975. This is an amount equal to 53 percent of the region's annual output (26 percent in 1975), or 325 percent of its exports of goods and services (166 percent in 1975). [1] Bank loans of $218 billion were outstanding to Latin America in mid-1983, representing almost three-fifths of all bank loans outstanding to developing countries. The debt is concentrated in the larger and more developed countries of Latin America: Brazil owes 27 percent of the area's foreign debt, followed by Mexico with 26 percent, Argentina with 12 percent, Venezuela with 10 percent, Chile with 5 percent, and Colombia and Peru each with 3 percent. In fact, the three largest debtors in Latin America are also the largest debtors in the entire developing world. [2]

More important than the growth in levels of debt over the last decade has been the rising burden of servicing that debt. Due to unprecedented increases in world interest rates in the early 1980s and the growing reliance of debtors on floating interest rate loans from commercial banks, as well as reduced demand for Latin American products during the recent global recession, debt service payments absorbed larger and larger shares of Latin America's export revenues, rising from 27 percent of exports in 1975 to 44 percent in 1981 and 65 percent in 1983. [3]

Growing arrears in debt service and the rescheduling of Latin American debt have become common in the last three years. In August of 1982, Mexico declared its inability to meet its debt obligations; Brazil and other countries followed shortly. In 1983, fourteen Latin American countries initiated negotiations with private and public creditors, either to refinance or reschedule existing debt, or to obtain funds to pay interest. Banks and debtor countries were negotiating $100 billion of reschedulings and new credits during 1983, and major banks from the industrial world had made loans that far exceeded their capital base. [4] In some cases, countries received official bridge loans pending adoption of adjustment programs with the International Monetary Fund (IMF).

Most Latin American countries have tried to keep up to date with their interest payments, but in some cases this has forced extreme domestic adjustment and austerity measures. Imports of goods necessary for consumption, investment, and domestic production have been severely curtailed: imports fell 20 percent in 1982 and another 23 percent in 1983. By 1984, per capita incomes had fallen 15 to 20 percent below their 1980 levels. [5] The obligation to service debt slowed down or halted the development process in many countries. Indeed, the 1980's may be a "lost decade" in terms of economic growth for the major debtor countries that have been in debt-servicing difficulty.

Concern over the implications of the debt crisis for the stability of developing economies as well as of the international financial system has led to a number of economic forecasts designed to project levels of debt, debt servicing capacity, and growth through the end of the decade. Prominent among the more optimistic of these forecasts are those of William R. Cline (1983, 1984); also included in this group would be the projections by Morgan Guaranty Trust (1983), Leven and Roberts (1983) at the Federal Reserve Bank of New York; Dooley *et al.* (1983) at the Board of Governors of the Federal Reserve System; and the most recent IMF forecasts (IMF, 1984). Under what are felt to be "reasonable" assumptions about world economic conditions (including moderate growth of real output in industrial countries of about 3 percent per year, and a decline in nominal interest rates to 9 percent in the late 1980's, as assumed in the Cline (1984) study), the severity of the debt problem for developing countries as a group is expected to recede substantially. Though the level of Latin American debt outstanding is projected to rise in nominal terms, the burden of servicing that debt (measured, for example, by interest and amortization payments as a percentage of exports) declines throughout the decade, returning to debt burdens common in the late 1970's. [6] Focusing on the largest debtors, Cline (1984) concludes that for Mexico, Brazil, and Venezuela the trend over time is unambiguously favorable, and it is positive but less strongly so for Argentina. Mexico and Brazil could return to voluntary lending by 1986–87; for Argentina, the return to voluntary lending may be significantly delayed because of the higher relative level of indebtedness. [7] Improvement is seen in Latin American growth rates, as imports will cease to be a major constraint on growth.

The hopeful conclusions of these forecasts are, however, predicated on what some believe are overly optimistic assumptions with respect to global economic conditions, the behavior of commercial banks, and the behavior of the Latin American governments themselves. Projections of debt and debt service are particularly sensitive to the assumed growth of economic activity in industrialized countries, and the concomitant response of those countries' demand for Latin American exports. If, for example, OECD growth were only 1.5 percent during the 1980's, large current account deficits could push major debtors into insolvency. Predictions of debt-servicing ability seem less sensitive to increases in nominal interest rates, though for some countries with particularly large debt relative to exports—this includes Brazil, Argentina, and Mexico—interest rate changes have a stronger effect. The optimistic scenarios are also based on an assumption that industrialized countries will not strengthen protectionist measures in the next few years. In the United States, developing countries competing with basic industries have recently become special targets for trade restrictions. The assumption that debtor governments will be willing and able to pursue demand-management and structural change policies may be more hopeful than political realities would suggest. And finally, most of the optimistic projections assume that commercial banks will continue to reschedule debt and that, once debt approaches more manageable levels, private capital markets will again consider developing countries creditworthy.

Some other forecasters, including Enders and Mattione (1984) of the Brookings Institution, Fishlow (1984) of the Overseas Development Council, and the Inter-American Development Bank (1984), come to less favorable conclusions. Enders and Mattione project that debt/export ratios for Latin American countries will decline by 1987, but by less than Cline predicts; moreover, they come to much more pessimistic conclusions regarding Latin American growth rates, especially for Brazil and Mexico. Fishlow forecasts only a moderate decline in debt burdens by 1986 for twelve major debtors, citing historical evidence of only modest responses of developing-country export prices and volumes to dollar depreciation and OECD recovery. Though most believe that a repudiation of debt obligations would be an unacceptably costly option for even the major debtors, they predict that the debt crisis in Latin America will last a long time.

### COMMERCIAL BANK LENDING

Before the first round of OPEC oil price increases in 1973-74, the external debt of developing countries was almost evenly divided between official and private creditors. Following the first oil shock, developing countries turned more to private creditors (mostly banks) to finance their current account deficits. This change in the structure of debt was particularly true for the newly-industrialized countries of Latin America. Thus, while the proportion of debt owed to official creditors dropped from 22 percent of the total at the end of 1975 to 12 percent in 1981, the private banks increased their share from 69 to 82 percent in that period. [8]

Commercial banks had rapidly expanded their loans to developing countries in the wake of the second oil shock of 1979-80. However, the Polish debt disruption of 1981 diminished the banks' willingness to undertake new lending to countries in Eastern Europe; by 1982, bank exposure in that region had fallen to slightly over half of its size relative to capital in the late 1970s. In a similar manner, commercial banks reacted to the economic and political difficulties faced by the Latin American countries in 1982 and 1983 by reducing new loans to the regions. In late 1982, following the suspension of principal payments by Mexico, the perception that there was a general Latin American debt problem became prevalent in the financial community. Bank lending to the seven largest Latin American debtors had grown at a 28.7 percent annual rate from 1978 to 1981, but it grew only 10.3 percent in 1982. [9] This slowdown in bank lending was an antecedent to the regionalization of the debt crisis that followed.

The more cautious lending posture of 1982-83 occurred as banks perceived a decline in the quality of their international assets, attributed to the failure of borrowing countries to adjust to the deterioration in the global economy. Indeed, the banks were responding to the concerns of their stockholders, who were becoming nervous about heavy exposure to developing countries, particularly those in Latin America. By mid-1984, this development was reflected in the nervousness in financial markets about the reliability of some major banks. A widely cited reason for the May 1984 siege on Manufacturers Hanover Trust was that the bank was heavily exposed in Latin America, especially in Argentina. The desire to reduce exposure to the heavily-indebted Latin American nations was particularly noticeable among the smaller regional banks, who had only a limited stake in the solvency of sovereign debtors. In the first half of 1984, although the U.S. money-center banks' foreign loan total held firm at $207 billion, the 188 regional banks active in foreign finance cut their overseas loans by $11 billion, to $139 billion. [10] This 7 percent drop in the regional banks' nominal exposure level occurred as the major debtors were facing an increased need for new lending.

Considerable uncertainty attaches to when the flow of voluntary or spontaneous lending to Latin America is to resume. [11] World Bank President A.W. Clausen recently warned that commercial bank lending to developing countries could, in the worst case, drop by 50 percent during the next decade. [12] At the very least, it is extremely unlikely that these countries will be able to rely on the amount of commercial bank financing that they did until 1982.

Pessimism concerning the ability or willingness of private banks to provide the flows of capital needed by Latin America in the 1980s has led to proposals for alternative forms of external financing. New official credits could come from an expansion in government loans on a bilateral basis (such as Export-Import Bank loans), or new multilateral lending from international agencies such as the IMF, the World Bank, and the Inter-American Development Bank. Some progress has been made in this area: late in 1983, after nine months of debate, Congress approved the U.S. share of an increase in IMF resources, totaling $8.5 billion over five years. [13] However, it is generally agreed that, due to the constraints on additional IMF resources imposed by political pressures in industrialized countries, as well as the need for long-term rather than short-term lending, other sources of external financing will be needed.

Increasingly, attention has been paid to the potential for foreign direct investment to provide a portion of the projected financing needs of developing countries. The Reagan administration has voiced support for "private market solutions" to the debt problem by increasing investment in the Third World. In late 1981, President Reagan unveiled a program for developing countries which stressed reliance on the private sector to lead development, [14] and in a 1983 statement reaffirmed the hope that foreign direct investment could resolve many of the current international debt problems.[15] On their part, many debt-ridden countries are beginning to encourage foreign companies to provide needed capital through direct investment. Though a few signs indicate that Latin American governments are making foreign investment tougher, the stronger trend seems to be one of softening restrictions. [16]

## A QUANTITATIVE ASSESSMENT

Foreign investment has a strong impact on many Latin American economies. Though foreigners have traditionally controlled less than 10 percent of all Latin American investment, a share less than the foreign share of investment in the Third World in general, certain countries and sectors receive a disproportionate part of the total. [17] Foreign investment in Latin America is highly concentrated in a few countries: four nations (Brazil, Mexico, Argentina, and Venezuela) account for over 80 percent of all foreign investment in the region's manufacturing sector (Table 1). In addition, foreign investment is systematically concentrated in certain sectors (e.g., manufacturing), and completely absent from others (Figure 1). As a result, foreigners account for a large proportion of output in some industries. Finally, the size of foreign corporations in Latin America is generally larger than that of their local competitors, giving multinational enterprises a degree of potential or actual market power that strengthens their impact on host countries.

The relative importance of foreign direct investment in the capital flows to developing countries as a group has been declining since the early 1970's. Though direct investment rose in absolute terms, bank credit became a much more dominant factor in private capital flows to the developing world (Figure 2). In 1973, foreign direct investment flows financed 20 percent of the combined current account deficit and net accumulation of reserves of non-oil developing countries, compared with an average of only about 12 percent in later years.[18] In Latin America, the share of foreign direct investment in 1983 gross external liabilities (the stock of foreign direct investment plus total outstanding external debt) was 11.6 percent for Argentina, 13.2 percent for Mexico, and 10.9 percent for Venezuela. Only Brazil, which receives the largest part of the flow of direct investment in the region, had a significantly larger share, 21.8 percent. [19]

The declining importance of foreign direct investment in private capital flows to Latin America occurred as commercial banks expanded their role as international financial intermediaries in the wake of OPEC oil price increases, facilitating the movement of funds from surplus to deficit countries. The rapidly expanding demand for medium- and long-term financing by developing countries was satisfied mainly by an expansion in commercial bank loans either to, or guaranteed by, developing-country governments. There was much less scope for large immediate increases in direct investment, which depended on the identification of individual opportunities for profitable investment and was influenced by a wide range of institutional restraints that could not be altered quickly. Thus it would have been difficult for foreign direct investment to provide a substantial proportion of external borrowing in the short term. Even so, the longer-term possibilities for substitution between direct investment and borrowing from commercial banks could be more significant.

What are the prospects for a substitution of foreign direct investment for commercial bank lending to Latin America throughout the rest of this decade? Most existing projections of the region's external financing requirements and equity investment flows show that the share of external financing accounted for by new foreign direct investment is not expected to be large. For example, Leven and Roberts (1983) predict a modest increase in direct investment in Latin America, from $4 billion in 1983 to $5 billion in 1987 (Table 2); this represents no increase in foreign direct investment in real terms throughout the decade. As a share of the total external financing required (equal to the projected current account deficit less accumulated foreign exchange reserves), this is an increase from 18.2 percent to 19.2 percent. According to Leven and Roberts, "direct investment could be much stronger than this if economic conditions improve and the proper incentives are provided". [20]

The Inter-American Development Bank projects financing needs in Latin America through 1990 under two alternative scenarios of economic growth. One is a "low growth" scenario that basically assumes a constant level of consumption per capita, and the other, a "high growth" scenario with growth rates which allow for increasing employment and labor productivity. [21] External financing needs in the high growth scenario actually decline from $22.8 billion in 1984 to $13.5 billion in 1990; in the low growth scenario, financing needs rise to $72.8 billion in 1990 (Table 3). In both cases, foreign direct investment flows to Latin America are assumed to increase only slightly, from $5.5 billion in 1984 to $6.5 billion in 1990. Thus only in the more optimistic scenario are flows of foreign direct investment a significant proportion of projected financing needs.

According to the IDS study, inflows of foreign direct investment are expected to increase most strongly for Mexico (from $200 million in 1983 to $1.2 billion in 1990), Colombia ($150 million to $400 million), and Chile ($200 million to $627 million); new foreign investment in Argentina and Venezuela is expected to increase somewhat, and direct investment in Peru and Brazil will remain constant or decrease. [22]

In the IMF projections of external debt and financing requirements for all non-oil developing countries, "foreign direct investment is assumed to grow at a somewhat higher rate than commercial bank exposure [or by an average rate of about 9.5 percent per year], reflecting a greater preference for this form of investment on the part of investing countries than was the case during the past decade, a greater effort by developing countries to obtain such investment, and the fact that investment opportunities in these countries are likely to be growing more rapidly than in the industrial countries". [23] Even using this higher growth rate, foreign direct investment would contribute only $6 to $8 billion of external financing to Latin America during 1987–90, compared to estimated financing needs of $15 billion to $25 billion (Tables 2 and 3).

From these projections it appears that although foreign direct investment into Latin America is expected to grow modesty throughout the 1980s, it is not anticipated to provide a large share of the projected external financing needs of the region. If only the direct "substitution effect" of replacing commercial bank lending with new inflows of equity financing are considered, Latin America will not be able to rely on direct investment as a solution to the debt problem. Nevertheless, foreign direct investment emerges as a more important contributor to the alleviation of the debt crisis if some possible indirect effects of foreign investment on Latin America's ability to attract and service foreign capital flows are considered.

## INDIRECT EFFECTS

The substitution of foreign direct investment flows for commercial bank loans as a source of external capital is essentially a substitution of equity financing for debt financing. With a bank loan, the debtor receives the use of the loan principal (owned by the creditor bank) for a stated period of time; the borrower's payment for the right to use that capital is the interest paid on the loan. If the loan is used to finance an investment project with a rate of return at least as great as the interest rate, the extra output produced will cover the interest payments on the loan. If the project is less productive, or if the loan is merely used to increase consumption, interest payments must be paid out of other resources, With foreign equity financing through direct investment, the debtor receives a "loan" of real resources (owned by a foreign enterprise) for a certain period of time. Payment for the use of those resources is made through profit repatriation to the home country. The amount of this "rent" paid to the foreign investor depends on the productivity of his investment.

This comparison of debt financing with equity financing underscores a possible advantage of substituting direct investment for bank loans for debtor countries. Interest payments on bank loans are either constant in nominal terms from year to year (if the interest rate is fixed) or vary with the current market interest rate (in the more common case of variable interest rate loans). With a fixed interest rate loan, the borrower may have difficulty servicing the loan during periods of slower growth or declining export revenues, as was the case for Latin American countries during the 1980-82 world recession. In other words, the ability to service debt is likely to vary with the business cycle, but the amount of debt service required does not. In the case of a floating interest rate loan, changes in the required debt service depend on changes in market interest rates, which may or may not vary directly with the business cycle. At the very least, a floating interest rate loan forces the borrower to assume the risk of fluctuations in interest rates. In contrast, "rental payments" on equity capital flows, made in the form of repatriated profits, are more likely to vary directly with the business cycle. During periods of slower economic growth in the host country, profits accumulated and repatriated on prior foreign investments are also likely to decline; during periods of stronger economic activity, the amount of repatriated profits would increase. Thus foreign direct investment brings the advantage of "procyclical interest payments" to the host country.

The available evidence seems to confirm this idea: for non-oil countries as a group, the correlation between the annual return on equity investment and the annual rate of growth of GDP is stronger than the correlation between GDP growth and the average interest rate paid on outstanding debt. This contrast in movements in rates of return and interest rates was particularly marked during the last recession. There is also evidence, however, that the share of earnings reinvested also fluctuates with changes in economic conditions. During the 1980-82 recession, remitted earnings declined much less than reinvested earnings in developing countries, particularly for direct investment in manufacturing sectors. [24]

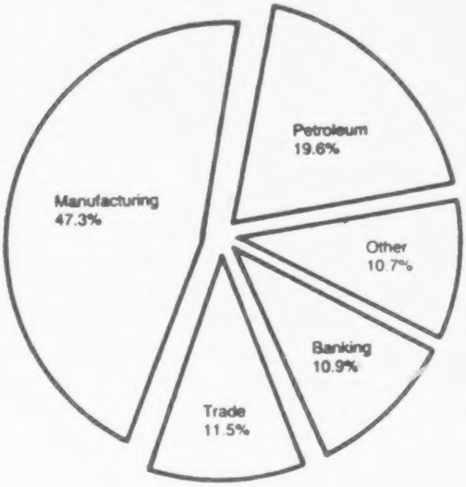
The role of foreign direct investment in the alleviation of the debt crisis may go beyond the potential substitution of equity financing for debt financing. It has been argued that commercial bank lending is complementary with official development assistance. In a similar vein, foreign direct investment may actually be complementary with commercial bank financing: increased private investment could serve to attract additional bank lending that would not have been forthcoming in its absence. This would occur if, for example, more private investment improved the perceived creditworthiness of Latin American borrowers. Thus foreign direct investment could play a role in the return to "voluntary" bank lending to the region.

Finally, if foreign direct investment has the effect of stimulating economic development in host Latin American countries, it will help to ameliorate the debt problem by improving those nations' ability to service existing levels of debt. For example, by augmenting investment in certain export sectors, private equity investment could bring needed foreign exchange to host countries; by stimulating production in import-substituting industries, private investment could help conserve on foreign exchange used for imports. If direct investment improves efficiency or factor productivity, the host country's capacity to service debt will grow.

The net effect of foreign direct investment on the path and speed of development is by no means clearly positive. In the next section of this paper, we consider the advantages and disadvantages of foreign direct investment from the standpoint of Latin American economic development. We concentrate on the effects of direct investment on some aspects of the development process that are crucial for a resolution of the debt crisis: the impact of direct investment on the hosts' balance of payments, on the efficiency of resource allocation in the receiving country, and on the transfer of technology between home and host countries.

FIGURE 1

The Distribution of U.S. Foreign Direct Investment in Latin America, 1982

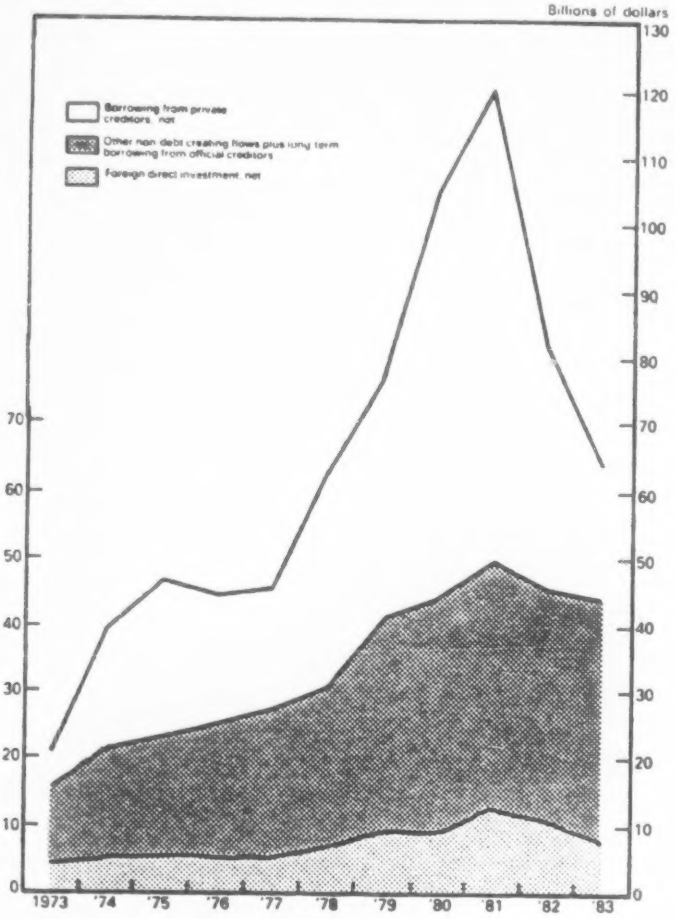


Total Stock $33.0 billion

Source: U.S. Department of Commerce (1984)

FIGURE 2

The Distribution of Financing Flows to Non-Oil Developing Countries, 1973-83



Source: Goldsbrough (1985)

## TABLE 1.—FOREIGN DIRECT INVESTMENT IN LATIN AMERICA: STOCKS, FLOWS, AND RELATIVE ECONOMIC IMPORTANCE, 1978–80

[Dollar amounts in millions of U.S. dollars]

| | GNP 1979 | Stock of FDI end-1978 | Flow from OECD 1978-80 average | FDI/GNP 1978-80 average (percent) |
|---|---|---|---|---|
| Latin America (all sources) | | | $4,901.6 | |
| Antigua | $90 | | 0.6 | $0.70 |
| Argentina | 60,310 | $3,340 | 637.4 | 1.06 |
| Bahamas | 650 | 2,060 | 435.6 | 67.02 |
| Barbados | 660 | 180 | 6.5 | .99 |
| Belize | 140 | 75 | | −.02 |
| Bolivia | 2,960 | 140 | −0.2 | −.1 |
| Brazil | 206,600 | 13,520 | 1,385.9 | .67 |
| Chile | 20,660 | 1,440 | 85.5 | .41 |
| Colombia | 27,790 | 1,510 | 96.6 | .35 |
| Costa Rica | 3,530 | 290 | 12.4 | .35 |
| Cuba | 8,550 | | | |
| Dominican Republic | 5,410 | 390 | 0.1 | |
| Ecuador | 8,980 | 660 | 9.0 | .10 |
| El Salvador | 2,800 | 150 | 4.9 | .17 |
| Grenada | 70 | | | .05 |
| Guatemala | 6,890 | 290 | 2.3 | .03 |
| Guyana | 500 | 230 | 0.6 | .12 |
| Haiti | 1,150 | 80 | 1.5 | .13 |
| Honduras | 1,870 | 270 | 0.8 | .04 |
| Jamaica | 2,400 | 900 | −21.1 | −.88 |
| Mexico | 122,920 | 6,000 | 1,186.3 | .97 |
| Nicaragua | 1,570 | 90 | 0.3 | .02 |
| Panama | 2,770 | 3,140 | 350.6 | 12.66 |
| Paraguay | 3,400 | 110 | 3.9 | .11 |
| Peru | 14,520 | 2,150 | 164.4 | 1.13 |
| St. Vincent/Grenadines | 50 | | | |
| Suriname | 910 | 420 | .5 | .05 |
| Trinidad and Tobago | 4,500 | 1,300 | 22.8 | .51 |
| Uruguay | 7,250 | 330 | 4.0 | .06 |
| Venezuela | 49,680 | 3,620 | 145.0 | .9 |

Source: United Nations Centre on Transnational Corporations, Transnational Corporations in World Development, Third Survey (1983).

## TABLE 2.—PROJECTIONS OF EXTERNAL FINANCING FOR LATIN AMERICA (LEVEN/ROBERTS)

| | Actual | | Projections | | | | |
|---|---|---|---|---|---|---|---|
| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
| Financing required | 43.0 | 23.6 | 22.0 | 25.5 | 26.0 | 25.0 | 26.0 |
| Current account deficit | 44.7 | 34.2 | 20.0 | 22.5 | 22.0 | 21.0 | 22.0 |
| Increase in reserves | −1.7 | −10.6 | 2.0 | 3.0 | 4.0 | 4.0 | 4.0 |
| Sources of financing | 46.5 | 27.8 | 22.0 | 25.5 | 26.0 | 25.0 | 26.0 |
| Official flows reserve related | 0.8 | 4.6 | 4.5 | 3.0 | 2.0 | −0.5 | −1.0 |
| Other official | 5.0 | 4.5 | 4.5 | 5.0 | 5.0 | 5.0 | 5.5 |
| Private flows: | | | | | | | |
| Banks | 31.1 | 11.3 | 9.0 | 13.0 | 14.5 | 15.5 | 16.5 |
| Bonds, net | 3.1 | 2.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Direct investment | 6.5 | 5.4 | 4.0 | 4.5 | 4.5 | 5.0 | 5.0 |
| Residual | −3.5 | −4.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Figures are in billions of U.S. dollars.

Source: Leven and Roberts (1983), table 1.

TABLE 3.—PROJECTIONS OF EXTERNAL FINANCING FOR LATIN AMERICA [IDB]

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| Historical data: | | | | | | |
| Current account deficit | 17.5 | 18.7 | 26.4 | 38.9 | 36.3 | 16.4 |
| Total external borrowing | 40.3 | 38.2 | 51.5 | 58.9 | 42.3 | 27.1 |
| Net external credits | 35.7 | 32.2 | 44.9 | 50.6 | 34.7 | 22.4 |
| Foreign direct investment | 3.9 | 5.0 | 5.6 | 7.0 | 7.1 | 4.7 |
| Transfers | 0.6 | 1.0 | 1.0 | 1.2 | 0.5 | 0.5 |

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|---|
| Projections (high growth assumed): | | | | | | | |
| Current accountant deficit | 1.5 | 13.3 | 15.3 | 14.2 | 12.9 | 8.7 | 5.0 |
| Total external borrowing | 22.8 | 21.5 | 23.8 | 22.6 | 21.2 | 17.0 | 13.5 |
| Net external credits | 17.3 | 15.5 | 17.7 | 16.4 | 14.9 | 10.6 | 7.0 |
| Foreign direct investment | 5.5 | 6.1 | 6.2 | 6.2 | 6.3 | 6.4 | 6.5 |
| Transfers | 0.7 | 0.9 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 |
| Projections (low growth assumed): | | | | | | | |
| Current accountant deficit | 15.4 | 22.4 | 32.5 | 36.4 | 44.4 | 52.0 | 62.5 |
| Total external borrowing | 23.3 | 31.9 | 41.3 | 45.7 | 53.9 | 61.8 | 72.8 |
| Net external credits | 17.9 | 25.8 | 35.1 | 39.5 | 47.6 | 55.4 | 66.4 |
| Foreign direct investment | 5.5 | 6.1 | 6.2 | 6.2 | 6.3 | 6.4 | 6.5 |
| Transfers | 0.7 | 0.9 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 |

Figures are in billions of U.S. dollars.

Source: Inter-American Development Bank, External Debt and Economic Development in Latin America (1984), table A.1.01.

## PART II. THE DEVELOPMENT IMPACT OF FOREIGN DIRECT INVESTMENT

In the words of Gustav Ranis, the role of the multinational enterprise in economic development has been subjected to one of the highest "heat to light" ratios in the economic and political literature. [25] In the conventional, neoclassical view, foreign direct investment is claimed to be a positive sum game for multinationals and host countries. Foreign direct investment is a vehicle that facilitates the transfer of resources from countries where they are abundant to countries where they are scarce. Through the magic of the marketplace, developing nations receive needed capital, technology, and managerial skills from the industrialized world. Multinationals can also provide jobs, access to foreign markets, and consumer products at lower cost. In this view, the presence of multinational enterprise in the host developing country is an augmentation of that country's capacity for doing what it wants to do.

Opponents of multinationals claim that foreign ownership and control of developing-country business enterprise inhibits economic development, or at the very least, alters the path of development. It is alleged that multinationals take more capital out of the host country than they put in; produce a mix of consumer products more suited to the luxury tastes of rich countries than of the basic needs of the developing world; transfer inappropriate labor-saving technologies to host countries, thereby worsening the problem of unemployment; and contribute to an uneven distribution of income, promoting social divisiveness. Much of the recent literature condemning foreign direct investment in the Third World has arisen from the Latin American dependency school, which has considered the multinational enterprise to be the basis of technological industrial dependence, replacing earlier forms of political and economic dependence. [26]

In evaluating the pros and cons of foreign direct investment in developing countries, it is important to keep in mind that neither multinational enterprises nor host developing countries can be neatly generalized. The term "multinational enterprise" encompasses a wide variety of forms of business organization, ranging from wholly-owned subsidiaries at one extreme, through various kinds of joint ventures, to licensing and management contracts, at the other. [27] Each of these forms can have very different effects on, for example, management training or the transfer of technical know-how. Neither is the host country a single agent or a homogeneous entity. The interests of the host country are a bundle of sometimes competing interests of different groups. Among those likely to benefit from foreign direct investment are some government officials, the small group of workers who enjoy high wages and job security, the satellite bourgeoisie to whom world-wide mobility and prospects are opened, and the domestic industries that supply multinationals or that produce complementary goods and benefit from the concessions obtained by multinationals. On the other side are the large groups of unemployed or underemployed workers, those who suffer higher costs or imperfect competition due to multinationals, the local competitors of multinationals, and those who dislike foreigners. [28] In view of this division, it is misleading to speak of the interest of "the" developing country, and evaluate whether foreign direct investment has provided a net benefit.

Finally, the role of the multinational enterprise in development cannot be assessed independently of the phase of development of the host country. [29] The idealized role of the multinational enterprise changes as the country moves through different stages of the development process. In early stages of development, a country may be pursuing import substitution policies, giving secondary importance to efficiency. At this time, when it is most important to channel investment in the industrial sector, the multinational enterprise can add to capital accumulation and savings. Under certain conditions, even wholly-owned subsidiaries can provide net benefits to the host economy. During a later stage of export promotion, when the industrial sector can be expected to be more self-sufficient and efficiency gains importance, the role of appropriate technology and output mixes is essential. In this period, the host country may benefit more by joint ventures then by wholly-owned subsidiaries.

## BALANCE OF PAYMENTS AND FOREIGN EXCHANGE IMPACTS

It can be argued that it is not important to be concerned with the effects of foreign direct investment on the host country's balance of payments, once the separate effects of foreign investment on real income have been assessed. This is because, at least theoretically, a country may eliminate any external deficit or surplus by following appropriate monetary, fiscal, and exchange rate policies. For example, if the country pursued a policy of allowing the value of its currency to be completely market-determined, incipient deficits would be removed automatically as currency depreciation caused imports to become more expensive, exports to become cheaper to foreigners, and as domestic incomes fell. In this view, it is irrelevant to consider the separate effects of foreign direct investment on the balance of payments since payments imbalances are attributable to government policy and not to foreign direct investment *per se*.

However, this argument ignores some of the important short-run balance of payments rigidities and constraints facing Latin American countries. First, since many countries confront such large and immediate debt servicing requirements, added to large merchandise trade deficits for some, the magnitude of the price changes and income reductions necessary to remove the deficits would be so extreme as to threaten economic stability and development efforts. In addition, the removal of external payments deficits through various adjustment mechanisms depends on the degree of response of import and export quantities to changes in incomes and relative prices. In cases where a large part of the import bill goes toward necessities, perhaps because austerity measures have already all but eliminated nonessential imports, raising the price of imports through domestic currency devaluation may, at least in the short run, lead to an increase rather than a decrease in the import bill. Similarly, for the many developing countries whose exports are heavily concentrated in primary commodities, reducing the world price of their exports through currency devalution may not be met with a significant increase in world demand. In these cases, the adjustment of balance of payments deficits through exchange rate devaluation may be unacceptably slow or even counterproductive in the short run.

The impact of foreign direct investment on the receiving country's balance of payments has long been a sensitive and controversial issue. In many developing countries, the prevailing view is that multinational enterprise operations result in a net foreign exchange loss to the host country. Support for this belief usually comes from the examination of the capital accounts in the host's balance of payments on an annual basis or over a period of several years. If net capital inflows from new foreign investment are exceeded by the net outflow of repatriated earnings on existing foreign investments, it is concluded that the operations of multinationals cause a net drain on foreign exchange reserves. For example, while the net flow of net investment into Latin America and the Caribbean ranged from $650 million to $1 billion annually between 1965 and 1970, repatriations of profits on existing investments varied in parallel from $1.4 billion to $2 billion. [30] According to these figures, multinationals caused a foreign exchange drain during the 1965–70 period at the rate of about $1 billion annually. During 1978–80, however, net inflows of new foreign direct investment, at $4.7 billion, exceeded the net outflow of payments on existing investment, at $2.6 billion. [31]

This type of calculation, widly used and accepted by opponents of foreign enterprise in developing countries, is accurate as to the capital accounts for the period in question but misleading as to the total balance of payments effects of multinational enterprises. At the very least, the evaluation should be made over a period of time long enough to cover fluctuations in capital flows caused by changes in macroeconomic conditions. For example, when the investment climate of a host country turns more risky for political or economic reasons, it can be expected that little new investment will take place and that profit repatriation will continue or increase, and vice-versa when the investment climate improves. An evaluation of balance-of-payments effects over only part of this period would give a misleading impression.

Inflows in the form of new capital and outflows of repatriated earnings represent some of the balance of payments impact. Outflows in the form of royalty fees and payments to headquarters for sharing company overhead are also important and should be included in the calculation. But in a quantitative sense, the capital flow effects of direct investment are generally overshadowed by the effects on the trade accounts—exports and imports. The direct balance-of-payments effects of a multinational enterprise in a given year (B) would be the sum of net capital and trade flows:

$$B=(X+K)-(M+R+E)$$

where X is the value of the multinational's exports; K represents inflows of equity capital and loans from abroad, including earnings retained out of profits, net of capital and loans repatriated; M is the value of the multinational's imports of capital goods as well as raw materials and intermediate goods (excluding finished goods imported for resale); R is the value of royalties and technical fees paid abroad after tax; and E represents net after-tax profits and interest accruing abroad, including retained earnings. [32] There is some evidence to support the claim that multinationals have a positive balance-of-payments impact when trade effects are taken into account. Lietaer (1979, p. 44) finds that U.S. subsidiaries in Latin America usually export two or three more than they import, thus making a net contribution to foreign exchange. Another study by an organization of U.S. multinationals estimated that during the 1965–68 period, U.S. affiliates were responsible for annual foreign exchange earnings by host countries through exports of about $4.5 billion and foreign exchange savings through substitutions for imports averaging at least $4.8 billion, or an average annual total balance-of-payments contribution of $9.3 billion on trade accounts alone. Over the same period, the annual amount of new capital invested in Latin America averaged about $700 million. Repatriated earnings on the accumulated investments were at a level of about $1,410 million annually. Thus, the annual deficit in the capital account of $740 million was overshadowed by an annual surplus of $9.3 billion on the trade accounts.

Insight into the impact of multinational enterprises on the trade accounts may be gained by comparing the trade behavior of foreign subsidiaries with that of their local counterparts. There are reasons to believe that, due to their different interests, foreign firms may have a higher propensity to import (measured, for example, as the value of imports as a proportion of the value of output) than do domestic firms. Multinationals that produce import substitutes may initiate local production through the assembly of imported components, gradually shifting to local inputs as supplier industries develop and relative costs shift in favor of local purchase. However, foreign firms may lag domestic firms in the process of domestic integration for several reasons: local inputs may be risky in quality and supply; the parent firms may profit from exports to captive subsidiaries; costs may be different due to economies of sale; and exports to subsidiaries from the parent can increase profits through transfer pricing strategies. [33]

Although some studies have shown no significant difference in import propensities between the subsidiaries of foreign-owned firms and domestic firms, the majority point to higher import propensities for foreign firms. Using a variety of methodologies, such findings are reported for Peru (Vaitsos, 1978), Mexico (Jenkins, 1979), and Brazil (Fajnzylber (1970); Newfarmer and Marsh (1981a,b)). In Mexico, it has been observed that the imports of foreign industrial enterprises make up almost half of the imports of capital goods by the private sector, and this percentage is greater than the actual share of these enterprises in industrial production. [34] According to a 1970 estimate, imports of intermediate goods as a percentage of the gross value of production was 7.8 percent for multinationals and 3.4 percent for local firms, while for imports as a whole this ratio was 11.9 percent for multinationals and 5.1 percent for all industries taken together. In 1970–73, the average trade deficit of multinationals was 47 percent of the total Mexican trade deficit. [35]

It might be expected that higher import propensities for multinationals would be offset by higher export propensities. On the other hand, there are reasons why multinationals might export either more or less than domestic firms. The multinational enterprise following a global strategy will supply its export demand from areas of lowest costs, or where excess capacity exists, or where national pressures or incentives for exporting are most effective. Multinationals may have better information than domestic firms about export opportunities and may have marketing operations already in place. However, it could be that with production facilities already in place in several markets, parents would discourage subsidiary exports on the grounds that such exports would be competitive with existing operations. [36] The evidence on the export propensities of multinationals in Latin America allows weak support for the conclusion that foreign firms have lower export propensities than do national firms, except in cases where the host government has created incentives for multinationals to export. [37]

The value of exports and imports directly from and to the multinational accounts for only part of the balance-of-payments impact of foreign investment. Some of the impact may be indirect: to the extent that multinationals stimulate economic development in the host country, they may produce a spinoff effect of increasing exports from local supporting companies. Conversely, a multinational's investment also affects local purchasing power, which can stimulate new imports.

Even after accounting for all direct and indirect effects of multinational enterprise operations on both the trade and capital accounts of the host country's balance of payments, there remains another major aspect of the question. Multinationals are highly skilled in forecasting foreign exchange risk and in protecting their assets against losses when balance-of-payments difficulties cause a country to devalue. They reduce foreign exchange risks by using local borrowing instead of bringing in outside funds, by accelerating payments for goods and services outside the country, and by advance repatriation of profits. In countries where multinational operations are large, financial strategies of such enterprises can easily place a critical amount of pressure on a currency when it appears to be weakening. [38] With the present-day problem of overvalued currencies in many Latin American countries, the anticipatory actions of multinationals could add instability to the process of realigning exchange rates.

### ECONOMIC EFFICIENCY

Frequently cited as a necessary condition for a gain in Latin America's debt servicing capacity is an improvement in the efficiency of internal resource allocation. [39] Governments of debtor nations are encouraged to "get relative prices right" through policies that free up prices, interest rates, and exchange rates, and rationalize tariffs. The hope is that this price rationalization will eliminate distortions and bottlenecks, thus providing extra productive capacity and improving external competitiveness, and improve the economy's flexibility in responding to external shocks by increasing the mobility of factors across sectors. [40] Foreign direct investment can influence efficiency in the host country through its impact on industrial structure and performance, employment and training, and the development of linkages between sectors.

In evaluating the influence of foreign enterprise activity on the efficiency of resource use in the host economy, it is important to avoid confusion arising from mistaken attribution. [41] For example, if a country's overvalued exchange rate encourages a foreign firm to import more intermediate goods and employ less labor than it otherwise would, is this problem attributable to the firm, or is it due to government policy? There is evidence that higher levels of market concentration and tariff barriers are associated with increased penetration by multinationals in many Latin American countries, but these distortions could be attributed to the operations of foreign enterprise directly, or to government policies designed to attract foreign investment, or to government policies designed to meet other economic objectives.

There is considerable theoretical support for the contention that multinationals by their very nature operate in imperfectly competitive markets. [42] According to these theories, a firm attempting to exploit profit opportunities abroad will decide to operate its own production facilities there, rather than licensing or subcontracting to local businesses, if the firm desires to appropriate the rents from a unique asset. This asset may be technological know-how that is not easily imitated by potential competitors, management skills, an existing marketing network, etc. Control of these assets by multinationals gives them a monopolistic advantage over local firms, and creates a market with a limited number of sellers.

Most of the empirical studies covering Latin America have tried to relate levels of concentration with the degree of foreign ownership in particular sectors or countries. The general conclusion of this work seems to confirm that multinational enterprises are a significant and growing force in the manufacturing sectors of most developing Latin American economies, that they are present in industries with high degrees of concentration, and that they are generally larger than domestic private firms. [43] In particular, multinationals tend to be found in high-growth, high-technology, and export-oriented sectors of the economy. [44] The structure of those host industries in which foreign firms cluster also tends to be highly concentrated, perhaps reflecting the structure of the home-country industry. This, together with studies showing strong correlations between market structures internationally, suggests that foreign direct investment is the bridge that links concentrated market structures. [45]

It is not possible, however, to infer from the evidence that multinational enterprises *cause* higher levels of concentration. Multinationals do operate in sectors that contain few sellers, but the causes of high levels of concentration may lie elsewhere—in economies of scale, marketing, finance, or organizational efficiency. These factors may lead to imperfect competition regardless of the nationality of firms. However, it is plausible that in developing countries the entry of foreign firms speeds up the natural process of concentration, and that the weakness of local competitors enables them to achieve a much higher degree of market dominance than would be the case in developed host economies. [46]

Several attempts have been made to assess the performance of multinational enterprises, both in terms of their efficiency relative to that of domestic firms, and in terms of their overall impact on host industry performance. One argument holds that multinationals are not only more efficient in production and distribution, but also that they raise the efficiency of other firms in the industry. Foreign firms could produce more efficiently if they have access to technologies that lower costs; to a greater number of markets from which the lowest-cost inputs can be chosen; or to global output markets such that the firms can operate at the most efficient rate of plant utilization. The multinational could induce a higher level of efficiency in established host-market firms via a demonstration effect or direct competitive influence. On the other hand, it is not clear that multinationals do use the lowest-cost production techniques in the host country. There is some evidence that multinationals that have entered a small host country behind tariff barriers operate at an inefficient rate of plant utilization. [47] Even though the cause of this excess capacity can be traced to host government policies, the result is a situation of productive inefficiency.

Generally, multinationals are more profitable than domestic firms, though profits are not a valid measure of efficiency in an imperfectly competitive market structure. Further, the practice of transfer pricing by multinationals makes the identification of efficiency or inefficiency more difficult. To the extent that multinationals shift profits out of the host country for whatever reason via transfer pricing, the apparent level of profitability in the host market will be misleading. Thus, evidence that industries in which foreign firms are heavily concentrated have no greater profitability than other industries may be unduly influenced by distorted data.

Another way in which foreign direct investment can stimulate development and increase efficiency is through the establishment of relationships with local suppliers and purchasers—backward and forward "linkages". These linkages are externalities created for domestic industry by the entry of foreign investment: particular investments may create such strong external economies in sectors that supply them or buy from them that new domestic investments are undertaken in order to exploit the opportunities.

Despite the empirical verification of linkage creation by multinationals, most studies do not address the question of the efficiency of those linkages. The issues to be raised are whether the host country could have created the linkages at lower cost in the absence of multinational activity, whether the linked local enterprises are desirable from a social point of view, or whether negative linkages were created by stifling potential local investment. [48]

In many cases, backward linkages developed in import-substituting industries have been found to be costly and uneconomical. In contrast, linkages created by foreign firms in export-oriented industries that compete in world markets have been found to be more beneficial, especially when the linkages are created by subcontracting. Of export-oriented multinationals, those most likely to create linkages are those which started by substituting for imports and have grown into internationally competitive enterprises with substantial export interests (for example, Volkswagen in Brazil), and those which produce and export traditional products. These activities usually involve technologies that are stable and not very sophisticated, and there exists a vast potential for linkages with domestic producers. Less likely to create linkages are foreign investments in modern industries using more complex technologies, or "sourcing" investments, where only a particular process is transferred to the host country. [49]

An empirical study of the development of backward linkages in developing countries via foreign-firm subcontracting reached the overall conclusion that these linkages, given proper government intervention, can be important to the host country for increasing local production and upgrading local industrial capacity. [50] One of the most important benefits of such linkages can be the transfer to technical knowledge to small local suppliers in particular, and the upgrading of the quality of their products, since small suppliers cannot as easily as large ones acquire technical knowledge via licensing from abroad. However, this study suggested that the extent, and perhaps also the nature, of linkages in developing countries depends not so much on whether the lead enterprise is domestic or multinational in origin, as on the industrial characteristics of its activity and, above all, on local government policy. The main difference between multinationals and domestic firms, given proper government policy, is not in their propensity to create linkages but in their ability to enter the relevant lead activity in the first place.

## THE TRANSFER OF TECHNOLOGY

Export growth will be of critical importance to Latin America in the years ahead, both because of its significance for development and because of its contribution toward financing essential imports and meeting the interest and repayment commitments on external debt. An essential condition for an expansion in exports will be the competitiveness of Latin American products in external markets. The need for export growth and diversification, along with the problems of unemployment and inefficient resource allocation, have renewed the debate on technology transfer from the industrialized world to Latin America through multinational enterprises.

Before examining the arguments on the extent or appropriateness of technology transfer through multinationals, it is important to differentiate between the various components of what normally goes under the name of "technology". First, there is existing knowledge about different ways of producing a given commodity in different situations of resource availability, and ways of devising new techniques. This is known as "production technology" and is the most obvious form of technology, but the definition can be broadened to include product design and sometimes managerial systems. Including the mix of goods produced in the definition of multinational enterprise technology has become more common among writers on the subject, and is consistent with the popular idea of technology (each new product improvement is labeled a technological advance), as well as with the common association of technology with research. Finally, there is a distinction to be drawn between the actual transfer of technology of either kind, and "fictitious" transfer—through patents, trademarks, etc.—as a device to preserve the multinational's monopoly power. [51]

A view held by many multinationals and their home country governments is that the technology produced in the advanced countries is appropriate to the needs of developing countries and that an efficient and adequate mechanism for transferring this technology is commercially, through multinational enterprises. Moreover, in the current stage of development of many Latin American countries, it would be costly or impossible for certain types of technology to be developed locally; therefore, this knowledge must somehow be imported from abroad. In many cases, imported technology may only be available through direct investment, particularly where the technology is the sole property of the foreign firm and is not willingly sold on a licensing basis. In addition, the benefits of technology transferred through multinationals may extend beyond the cost savings or productivity increase in the particular investment made by the multinational. Externalities such as the inducement of more modern techniques in competing firms, stimulation of complementary research and development activities in the recipient firm or its suppliers, or improvement in the quality of local factors of production (particularly the training of labor) can be a boost to the development process in the host country. Proponents also claim that multinationals can benefit host countries by providing, very quickly, the production facilities for a wide range of modern products. Capital or intermediate goods offered by multinationals can raise the productive efficiency of other industries in the host economy; consumer goods produced by multinationals can raise consumption benefits by providing a wide range of choice.

On the other side of the issue are those who feel that technology transfer through multinationals actually hinders development in the receiving country, and reduces the host country's ability to make future innovations on its own. In this view, the technology transferred by multinationals reflects economic conditions in the home countries; it is designed to conserve on costly labor in the production process, and is directed toward the production of high-income, sophisticated consumer goods. Hence, it is felt that the technology transferred is inappropriate to the needs of the host developing country, both because it is biased against the use of abundant labor, and because the mix of output produced by that technology is not suited to the host's consumption needs in its present stage of development.

Second, critics of technology transfer through multinationals point out that the important "spillover" effects of the diffusion of information *within* multinationals are not automatic. They cite the theoretical and empirical evidence that multinationals operate in concentrated industries in which rents are gained from proprietary ownership of technological know-how. This implies that the interests of the multinational in maintaining ownership of its "knowledge assets" is in direct conflict with the host country's desire to acquire that technology from the foreign firm. Similarly, since multinationals attempt to appropriate rents from a package of technological, managerial, and marketing assets that can be applied with little adaptation to different areas, it is not expected that they will make major alterations to suit the relatively small markets in developing countries. Minor adaptations may be made to suit local conditions, to meet official requirements, or to save foreign exchange, but by their very nature, multinational enterprises do not specialize in the simple, labor-intensive products which can be adapted to developing-country factor endowments.

Finally, the critics claim that multinational enterprises are the "institutionalization of technological dependence". [52] Technological dependence refers to the continuing inability of a country to generate the knowledge, inventions, and innovations necessary to propel self-sustaining growth. Because multinationals bring to the host country technologies that have been developed abroad, the host does not learn the research and engineering skills necessary to continue technology growth, and does not create the critical mass of innovation necessary to spur development. Proponents of this view cite the experience of Japan, which did not permit the establishment of foreign subsidiaries in the postwar period. Instead, the Japanese spent heavily on purchases of licensed technology from abroad, as well as on domestic research and development. It is argued that the transformation of Japan into a world industrial leader would not have occurred if foreign multinationals had been allowed to control technology-intensive manufacturing industries.

What kinds of technologies are "appropriate" for the developing economies of Latin America? Most studies on the appropriateness of production technology in developing countries have defined technology in terms of the ratio of labor to capital employed. [53] Since developing countries are presumed to be endowed with a large amount of labor relative to capital, an appropriate production technology would be one that employed large quantities of labor relative to capital. However, labor intensity alone is an insufficient criterion upon which to judge appropriateness, for a number of reasons: (1) Labor is not a homogeneous factor; an appropriate technology would be one that uses greater quantities of the *types* of labor (usually unskilled) that are found in the host developing country. (2) Capital is not the only scarce resource in developing economies; other factors such as managerial skill, foreign exchange, or certain materials may be in short supply. A measure of appropriateness would include the intensity of all factors employed. (3) Even a technology that uses large amounts of abundant factors and small amounts of scarce factors may not be the most efficient, if there are alternative technologies that use less of all factors; the country would waste all resources if it chose an inefficient method. Rather than relying on a single-dimensional definition of appropriateness based on labor intensity, a better definition would be "the set of techniques that makes optimum use of available resources". [54] In addition to making efficient use of available resources, an appropriate technology also enhances the quality of those resources.

The question of whether or not multinational enterprises use appropriate technologies in host developing countries can be addressed in two ways. First, do multinationals make technology choices different from those of local firms in similar industries? Second, even if multinationals are not different from local firms in this respect, do they choose the *most* appropriate technologies? To answer the first question, the ideal procedure would be to compare matched sets of foreign and local firms, making similar products, with equal access to the relevant technology and facing identical market conditions. Unfortunately, there are few cases where such close comparisons can be made. Most studies have resorted to comparing large and diverse groups of foreign and local firms. In general, existing studies of this type for Latin America do not indicate overwhelming evidence that multinationals adapt less to local resource availability than do local firms. [55] An exception is a study by Newfarmer and Marsh (1981b), which through a comparison of a matched sample of Brazilian firms in disaggregated industries, found multinationals to be consistently more capital-intensive than local firms.

While there is no conclusive evidence that multinational enterprises choose less appropriate technology than do local firms, neither is there strong evidence that they use the most appropriate technology. Virtually all studies on the subject conclude that there is great potential for further adaptation. [56] For example, studies of Brazilian firms by Morley and Smith (1977a,b) found that multinationals in manufacturing industries had indeed switched to more labor-intensive methods, but most changes involved "scaling down" for the Brazilian market and usually replicated smaller scale plants operating in high-wage countries. Morley and Smith explain this finding by noting that the competitive pressures faced by multinationals may be so weak that they are able to meet their profit targets and other goals without searching for and employing the less familiar, more labor-intensive techniques. Thus the failure of multinationals to adapt their production techniques more fully to labor abundance arises from a "permissive environment", which allows multinationals to produce profitably without searching extensively for technological alternatives. The firms may be engaging in "satisfying" behavior rather than maximizing profits. Hence, the problem may be better described as one of imperfectly competitive market structures rather than of the nationality of firms.

Technology transfer through multinational enterprises may also affect the quality of resources available for future use by the host country. Usually, this means the training of employees in operative, management, or research skills. Theoretically, these skills are then transferable to other uses in the host economy. Here, there is evidence to suggest that foreign firms in Latin America do engage in extensive training of the workers in their affiliates, sometimes because of government requirements, but usually to further the company's productivity or sales. [57] Frequently cited are the formal courses or on-the-job training given to employees, or training given to suppliers to ensure that they will meet quality or delivery goals. Training in management techniques is common in cases where the foreign firm is attempting to replace expatriate managers with local employees. Since multinationals have tended to concentrate in technology-intensive industries, they also have been an important source of training in the use of technology. It has been estimated, for example, that IBM alone accounts for about half the training of computer users in Latin America. [58] There are also indications that multinationals lose many of the workers they have trained to local enterprises, generating the transfer of skills to the host country.

Finally, some studies have considered the issue of the creation of technological dependence by multinationals in Latin America. In this area, it does appear that domestic firms are more likely to invest in knowledge-creating activities than are the subsidiaries of foreign firms. The basis of the technology owned by multinationals is research and development carried out almost exclusively in home countries. What research and development that has been undertaken in host countries has been funded by local enterprises. [59]

## HOST GOVERNMENT POLICIES TOWARD FOREIGN DIRECT INVESTMENT

Latin American national and regional policies toward foreign direct investment present a mixture of incentives and restrictions designed to attract or regulate foreign investments in particular industries. The policies used by host governments to shape and control foreign direct investment can be categorized into four general types: (1) the setting of investment priorities by official screening and approval procedures; (2) investment incentives; (3) performance requirements, including the requirement of domestic ownership and control; and (4) restrictions on the repatriation of profits and earnings. [60]

In most of Latin America, foreign direct investment proposals are subjected to some form of screening. Screening mechanisms are often particularly concerned with the contribution an investment will make to the host country's technological capabilities, foreign exchange earnings, productive capacity, employment, and its effects on imports and exports. In some cases, the screening process provides a negotiation opportunity in which performance requirements can be imposed upon the foreign investor.

Investment incentives are generally of a tax nature but may involve protective tariffs, export rebates, and cash grants. Credit guarantees, interest subsidies, and benefits for training purposes are also used by some Latin American governments. As is frequently the case with screening processes, investment incentives are often tied to performance requirements—the "carrot-and-stick" approach. Income tax exemptions are widely used, but most countries also allow reductions or exemptions from import duties in some situations. Many countries either provide or subsidize infrastructural facilities (roads and buildings) and public services (water and electricity). Some incentives are conditional on a firm setting up its operation in a free-trade zone.

Governments impose numerous kinds of performance requirements, including required levels of exports or limitations on imports; required or negotiated levels of domestic ownership; required numbers of nationals on the boards of directors or other positions; guaranteed levels of domestic employment; training of nationals; minimum levels of plant and equipment or research and development expenditures in the host country; minimum levels of local content of labor and raw materials; and exports of a value sufficient to offset the cost of imported primary inputs. Performance requirements set by a country may also vary from sector to sector, with lesser requirements in those sectors where foreign direct investment is most desired.

There are many ways in which the repatriation of capital, or the remittance of dividends, interest, fees, or royalties to the foreign parent company can be restricted. Most Latin American countries have generally similar policies toward capital repatriation and the remittance of profits. In most, capital may be repatriated upon liquidation of a company or in some cases several years after the initial investment. Dividends can be remitted from nearly all Caribbean countries without significant restraint. Some nations limit annual profit remittances to a certain percentage (usually 20 percent) of the investor's registered investment base. Reinvested profits will usually increase the registered investment base, thereby raising the limit for future remittance of dividends. Dividends can sometimes be remitted above the established percentage but are then taxed at relatively high rates.

There is a good deal of variation among different Latin American countries in the degree of control they exert over foreign investments. Mexico, for example, is often seen as having a "socialist" model of foreign investment policy, while Chile's policies are characterized as being "laissez-faire capitalist", and Brazil's model falls somewhere in between. Foreign investment policy in Mexico emphasizes majority control by nationals in most cases. Foreign investors who wish to engage in joint ventures are welcome, particularly those who bring labor-intensive technologies or who contribute to the geographical decentralization of the economy; those who have a favorable effect on the balance of payments and who will integrate in their production the largest amount of local raw materials; and finally, those who do not reduce the local sources of credit for local firms and who will not impose patterns of consumption judged to be inappropriate. Certain economic activities are the preserve of the Mexican government: petroleum, energy, mines, electricity, railways, and telegraphic and radio communication. Others are reserved for Mexican firms, without any foreign participation: radio and television, urban and interurban transport services, air transport, the exploitation of forests, and gas distribution. In other industries, foreign participation is allowed according to certain maximum shares, up to a limit of 49 percent. [61] Most recently, however, Mexico has begun to relax its restrictions on foreign investment: for example, the government seriously considered allowing International Business Machines Corporation to set up a 100-percent-IBM-owned personal computer factor. [62]

In contrast, the policies on foreign direct investment followed by the present Chilean government have been described by international investors' organizations as being among the most liberal in Latin America. The rules of the game are based on three guiding principles: equality of treatment for both foreign and local investors; free access of multinational enterprises to the various economic sectors of the country; and nonintervention by the government with regard to the activities of foreign investors in the national economy. [63]

Equal treatment for both foreign and local investors results in extreme simplification of the rules on direct investment. There are almost no special obligations or restrictions imposed on multinationals: they have access both to domestic credit and to government contracts, and are eligible for all the regional or sectoral incentives already existing or to be adopted in the future. In fact, multinationals have some advantages over local firms: free remittance of profits and repatriation of capital after three years, without any subsequent time limit; maintenance of a constant tax rate for a prolonged period; and other advantages regarding taxation.

Chile has virtually no limitations on the participation of foreign-owned firms in particular industries. Exceptions are generally industries of minor economic importance, and in those cases where they are important—gas, oil, and uranium—exploration and operating contracts can be signed with the government. There are no nationality requirements that would prevent an enterprise from carrying out any normal economic activity, no restrictions on the purchase of public or private domestic enterprises by multinationals, and no limit on the percentage of mineral reserves that can be controlled by foreign enterprises.

Between the Mexican and the Chilean varieties of foreign investment policy is the Brazilian system, which some consider to be a model of the kinds of demands, bargaining posture, and regulations that multinational enterprises will encounter in other nations as they develop economically and politically. In Brazil, attitudes toward multinationals are favorable but not uncritical. The basic commitment is to encourage a continuous flow of capital, to treat the foreign investor fairly, and to accept modes of resolving conflict typical of the industrial world. Policies are designed to choose the kinds and levels of foreign direct investment that fit with the development needs and priorities of the nation.

Foreign direct investment in part of Latin America is also regulated to some extent by the Foreign Investment Code of the Andean Pact, a regional agreement between Bolivia, Colombia, Ecuador, Peru, and Venezuela. [64] Decision 24 of the Andean Pack establishes a common set of rules that are the minimum restrictions to be applied by each government to foreign capital, allowing governments to legislate stricter norms if they so desire. The Code was designed to create strict but stable norms that would attract and regulate the sorts of foreign investment that effectively support internal development efforts.

The implementation of the Andean Foreign Investment Code has varied widely from country to country. In most cases, the laws enacted by each member country have failed to reproduce the provisions in Decision 24—usually allowing more lenient controls. Peru is considered by some to be the most restrictive country, followed by Venezuela; Chile, until it withdrew from the Andean Pact in 1976, was the most open, preceded by Colombia. Altogether, the impact of the Andean Code appears to have been substantial both on entry decisions and on operating flexibility of multinationals. The amount of incoming foreign investment slowed in the first of the Code's existence, and a significant shift in ownership at entry has occurred in favor of joint ventures with host-country partners, away from 100 percent foreign ownership. In addition, foreign investors have been very much limited in their ability to move funds out of Andean Pact host countries. [65]

A look at history reveals that Latin American governments' behavior toward multinationals has varied cyclically over time. [66] The cycle has consisted of a period of welcoming multinationals with open arms, alternating with outbreaks of nationalism. An extreme example of this variation in policy was seen in Chile during the last two decades. For many years, up to 1970, the mining sector in Chile was dominated by foreign investment, and received almost 60 percent of all foreign investment in that country. Following a change in foreign investment policies in 1970 and the nationalization of the large-scale Chilean copper industry, the mining industry's share of foreign investment in Chile went down to less than 20 percent. The industrial sector increased its share of foreign investment, the share of services fell sharply, and that of the financial sector almost disappeared: by 1973, there was only one foreign bank left in the country. Foreign investment policies were subsequently liberalized after 1973, and during the 1974–79 period, mining renewed its importance in new foreign investments.

There have been both economic and political reasons for this cyclical policy behavior toward multinationals in Latin America. The chief economic reason is the shifting balance of bargaining power between multinational enterprises and host governments, which fluctuates with certain specific sectors' needs for reinvestment. Especially in the case of large-scale, high-fixed-cost investments, the bargaining power of the multinational via-a-vis the host government tends to fall after the major investment has been made and profit remittance rises. Additionally the alternation of national-populist governments with conservative and free-trade oriented governments creates an uncertain climate for foreign investment. [Political instability results from Latin America's extreme social polarization: the absence of a strong middle class means that extreme political differences are not counterbalanced by a moderating influence or by a tendency to seek compromise. Therefore, when political power shifts from one group to another, government policy changes much more radically than when the same situation occurs in most Western industrialized countries.]

Nevertheless, if foreign direct investment is to make a larger contribution to the development process and to a more manageable mix of external capital flows to Latin America, policy stability is crucial. Latin American experience with foreign direct investment has shown that multinational enterprises will continue to invest even when host government policies are fairly strict, as long as they believe the policies will be stable and consistent. And, while foreign investors are concerned about specific host government policies toward direct investment, their investment decisions may be even more strongly influenced by the stability and rationality of general macroeconomic policies in the host country. In this sense, "what's good for IBM is good for Latin America", and regaining the momentum of growth and development that was lost in the debt crisis can be a positive sum game for Latin America and foreign investors.

## APPENDIX. ENDNOTES

1 Inter-American Development Bank (1984), p. 13; Enders and Mattione (1984), p. 1.
2 Inter-American Development Bank (1984), p. 3.
3 *Ibid.*, p. 3.
4 Enders and Mattione (1984), p. 1.
5 Inter-American Development Bank (1984).
6 Leven and Roberts (1983).
7 Cline (1984), p. 8.
8 Inter-American Development Bank (1984), p. 4.
9 Enders and Mattione (1984), p. 31.
10 "Many Regional Banks Reduce Foreign Loans, Raise Tough Problems" *Wall Street Journal*, November 19, 1984.
11 International Monetary Fund (1984).
12 *Wall Street Journal.* November 19, 1984.
13 Enders and Mattione (1984), p. 51.
14 See Newfarmer (1982), p. 1.
15 This statement is reprinted in U.S. Dept. of Commerce (1984), p. 85.
16 *Wall Street Journal*, November 19, 1984.
17 Lietaer (1979), p. 21.
18 Goldsbrough (1985), p. 31.
19 *Ibid.*, p. 33.
20 Leven and Roberts (1983), p. 10.
21 Inter-American Development Bank (1984), p. 59.
22 Inter-American Development Bank (1984), Tables A.1.01-A.1.10.
23 International Monetary Fund (1984), pp. 69 and 158.
24 Goldsbrough (1985), p. 34.
25 Ranis 1976), p. 96.
26 For a comparison of contending perspectives on the impact of the multinational enterprise on development, see Biersteker (1978).
27 Ranis (1976), p. 97.
28 Streeten (1971), p. 257.
29 Ranis (1976), p. 97.
30 Lietaer (1979), p. 44.
31 United Nations Centre on Transnational Corporations (1983a), Table II.2.
32 Lall and Streeten (1977), p. 130.
33 Newfarmer (1982), p. 20.
34 Marinho (1981), p. 16.
35 Fajnzylber and Tarrago (1976), p. 520.
36 Newfarmer (1982), p. 21.
37 Studies that show a lower export propensity for foreign firms include Vaitsos (1974) for Brazil, Argentina, Mexico, Colombia, Peru, and Venezuela; and Fajnzylber and Tarrago (1976) for Mexico. A study for Central America (Willmore 1976)) found that multinationals exported slightly more than domestic firms. Newfarmer and

Marsh 1981b), for Brazil, found no significant difference, even when controlling for industry.

38 Robock *et.al.* (1977), p. 191.

39 See, for example, International Monetary Fund (1984).

40 Taylor (1984), p. 148.

41 Frank (1980), pp. 33–34.

42 This theory is based on the work of Hymer (1960), Kindleberger (1969), and Caves (1971), among others.

43 These studies include Fajnzylber and Tarrago (1976) and Sahagun (1976) for Mexico; Newfarmer and Mueller (1976) for Mexico and Brazil; Sourrouille (1976) for Argentina; Willmore (1976) for Central America; Zeitlin (1974) for Chile; and Chudnowsky (1973) for Colombia; see Lall (1978) for a survey of these studies.

44 Perry (1979).

45 Newfarmer (1982).

46 Lall (1978), p. 229.

47 Parry (1979).

48 Lall (1978), p. 218.

49 Lall (1978).

50 United Nations Centre on Transnational Corporations (1981).

51 Moxon (1979), p. 191; Ranis (1976), pp. 106–07.

52 Newfarmer (1982), p. 20.

53 Moxon (1979), p. 194.

54 Moxon (1979).

55 These studies include Strassman (1968) for Mexico and Puerto Rico; Lall and Streeten (1977) for Colombia; Vaitsos (1976) for Peru; and Fajnzylber (1975) for Mexico.

56 Lall (1978), p. 238.

57 Moxon (1979), p. 203.

58 *Ibid.*, p. 203

59 See, for example, Newfarmer (1980) for Brazil; Gereffi (1982) for Mexico; and West (1982) for Argentina.

60 U.S. Dept. of Commerce (1984), p. 31.

61 Montavon (1979), pp. 13–17.

62 *Wall Street Journal*, November 19, 1984.

63 Lahera (1981).

64 See Robinson (1976) and Grosse (1983).

65 Grosse (1983).

66 Lietaer (1979), p. 51.

67 *Ibid.*, p. 51.

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# REGIONAL ECONOMIC INTEGRATION IN LATIN AMERICA

By Mario I. Blejer*

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## SUMMARY

Three different types of integration schemes have been tried in Latin America: (1) the Latin American Free Trade Association (LAFTA) which was committed to the gradual elimination of barriers to intra-regional trade; (2) subregional common markets like the Andean Group, the Carribean Community (CARICOM) and the Central American Common Market (CACM); and (3) the Latin American Integration Association (LAIA) a kind of regional General Agreement on Tariffs and Trade (GATT).

Although LAFTA achieved some reduction in trade barriers in the middle 1960's, very little progress was made thereafter. Among the main reasons for LAFTA's limited success were the lack of a mechanism to distribute costs and benefits equitably, the failure to harmonize commercial and exchange rate policies and sharp differences over development strategy.

The subregional arrangements attempted to overcome LAFTA's deficiencies by providing for a more global and automatic tariff reduction process. In practice, though, the establishment of a common external tariff, industrial planning and harmonization of commercial and investment policies proved too difficult.

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A new attempt to increase intra-regional trade was made with the founding in 1980 of the Latin American Integration Association. The Association provides a framework within which members bilaterally negotiate access to each other's markets, while maintaining customary protection against third countries.

The inherent difficulties of reconciling the myraid conflicting interests of many countries varying greatly in economic development were further magnified by external shocks of the late 1970's and early 1980s. Contributing even earlier to the waning of the integration effort was the sharpening of ideological conflict between advocates of protection and import substitution on the one hand and proponents of global Latin American trade liberalization on the other. Advocates of the latter approach were primarily the military regimes of Argentina, Chile and Uruguay.

The apparent failure of the military regimes' attempt at economic liberalization and the increasing protectionism in the industrialized countries seem to have reversed the trend against regional economic integration. On the other hand, the debt and financial crisis of the Latin American countries may impose new obstacles to the process of formal integration. A more feasible approach to integration may be the encouragement of economic cooperation in many areas outside the formal integration framework.

## PART I. INTRODUCTION

### BACKGROUND

Formal and informal agreements among groups of countries establishing generalized tariff preferences for their members are not a new phenomenon. Historically, the best known customs union is the Zollverein, formed in 1834 under the leadership of Prussia, which paved the way for the political unification of Germany. In our days, probably the most successful example of economic integration is the European Economic Community. Many of the well known examples of integration are of countries that had reached a relatively high level of economic development.[1] Economic integration of developing countries became a very topical issue in the 1960's.

The first section of this overview briefly discusses policy issues related to economic integration, including tariffs, exchange rate, and export-promotion policies. The second section focuses on the Latin American experience. It discusses the concepts underlying the various subregional integration arrangements and highlights the main stumbling blocks to the process. The third and final section reviews the integration experience in the light of recent world and regional developments and offers some thoughts on alternatives to the conventional forms of integration and regional cooperation. An appendix, which is omitted from this abridgement, surveys the theoretical economic framework of economic integration, including the traditional approach, extensions of that approach, and modifications introduced for adaptation to developing economies.

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[1] The framework within which colonial trade relations took place in the middle of last century can be regarded as a regime of commercial preference, but since those relations reflected the dependency of the colonies and their unequal access of the metropolitan countries, it hardly qualifies as an example of integration.

### POLICY ISSUES

One of the major benefits expected from an integration effort is the gains arising from intra-union specialization and exploitation of economies of scale. The efficiency with which these benefits would be exploited depends to a large extent on the tariff policy adopted. But tariff protection is frequently biased against both manufactured and primary exports because it entails a rise in the domestic price of imports and a reduction in the domestic export prices due to a lower associated equilibrium exchange rate. This overvalued exchange rate tends to discourage exports and shift the allocation of resources from a potentially more efficient export sector to a less efficient import-substituting sector. This bias of tariff protection could be offset by a policy of compensating export subsidies. But since a blanket export subsidy on all exports equal to the external tariff rate is clearly inappropriate, the whole question of the structure and composition of export-promotion measures within the union arises directly in connection with the structure of the common external tariff. Since the exchange rate effects of a given tariff will tend to be different across member countries, the compensating subsidy will also have to differ, which will be an additional source of potential conflict among members.

The level and structure of the common external tariff is a potential source of conflict between the more protectionist partners, which will push for a higher tariff structure to avoid the elimination of existing local industry, and the more "efficiency oriented" countries, which will push for greater financial and trade liberalization.[2]

Furthermore, non-tariff restrictions between members detract from free intra-union trade. If applied non-uniformly to non-union countries, they will affect the industrial structure envisaged in the design of the common external tariff. Moreover, divergent *de facto* protection may lead to trade deflection, i.e., goods entering the union through the less protective member. This possibility could impose administrative burdens on union members, which need to ascertain the real origin of intra-union merchandise trade.[3]

The success of economic integration programs is contingent on the achievement not only of consensus on tariff policies, but also of some type of understanding on fiscal, monetary, and exchange rate policies. Divergent fiscal and monetary policies may lead to serious distortions in the intra-union pattern of trade. Under fixed exchange rates, contractionary fiscal or monetary policies, or a currency devaluation of one of the members, has the equivalent effect of an export subsidy, and gives that member an improved trade position with respect to its partners. Inflationary policies, export taxes, and real currency appreciation have the reverse effect. If distortions in the pattern of production and the emergence of serious intra-union trade imbalances are to be avoided, these policies must be aligned.

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[2] These restrictions may include licenses, quotas, exchange controls, prior deposits, health and packaging regulations, etc.

[3] This problem, which is well known in free-trade areas, is supposed to be eliminated by the formation of common markets, whose distinguishing feature is a common tariff vis-a-vis the rest of the world and free factor mobility.

On the other hand, under flexible exchange rates, internal policy divergences do not necessarily have detrimental effects, since exchange rate adjustments would offset them. Still, discriminatory financial policies, such as tax credit and incentives, selective credit policies, accelerated depreciation, and the like, require harmonization if intra-trade distortions and unfair competition designed to affect the location of regional investment projects and to attract new foreign investment are to be avoided. In general, flexibile exchange rates may not lead to perfect regional balance since, in many regions, for example Latin America, intra-regional trade is only a small fraction of the total trade of each member.[4] Moreover, a generalized floating exchange rate system can eliminate distortions and imbalances only if real sector adjustments are very fast; otherwise there will probably be exchange-market interventions and consequently large swings in the structure of intra-union relative prices and instability in the payments position of the member countries. However, the maintenance of a bilateral trade balance should not be a required objective; if it is, it may lead to large departures from specialization based on comparative advantage.

Whatever the exchange system finally adopted, some sort of fixed exchange rate in real terms is clearly required if the frictions that are bound to arise from large and chronic payment imbalances are to be avoided. Whether this rate is to be attained by harmonization of domestic fiscal and monetary policies, or by coordinated management of exchange rate policies, is a practical question. The resolution of this question is crucial for the stability of any integration project; the uneven distribution of costs and benefits will cause instability and tensions, and what may be perceived as unsustainable intra-trade imbalances will emerge.

## PART II. HIGHLIGHTS OF THE LATIN AMERICAN EXPERIENCE WITH ECONOMIC INTEGRATION

The first steps toward Latin American integration were taken in the 1950's but no concrete framework was established until 1960. Since then, three different types of integration systems have been implemented with different, degrees of success. The first, the Latin American Free Trade Association (LAFTA), attempted to gradually eliminate barriers to intra-regional trade without establishing a common external tariff or providing for any substantial measure of domestic or external policy coordination. The second type was the creation of subregional common markets, like the Andean Group, the Caribbean Community (CARICOM) and the Central American Common Market (CACM). The common markets were true customs unions with a much larger degree of policy homogeneity. The third model is represented by the recently established Latin American Integration Association (LAIA),[5] which provides a framework for negotiation of multilateral trade agreements based on initial bilateral agreements. The operational structure of this Association could be characterized as a regional General Agreement on Tariffs and Trade (GATT).

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[4] For a discussion of this issue, see Conesa (1983).

[5] Associación Latinoamericana de Integración (ALADI).

### THE FREE TRADE AREA MODEL (LAFTA)

In the late 1950's, regional economic integration was regarded as a means of continuing the process of import substitution and improving the terms of trade, which had deteriorated during the decade. The larger developing countries that had achieved gains in industrial productivity saw regional integration as a way to eliminate both domestic market limitations and the need to penetrate the markets of the industrialized countries, a task they perceived as extremely difficult. The opening of a larger market highly protected from the rest of the world would enable the import-substitution process to be deepened at the regional rather than at the national level.

However, the different levels of progress of the various members in the process of import substitution were bound to result in a very unequal distribution of benefits.

Widespread acceptance of economic integration as a means of advancing economic development led to the signature, in 1960, of the Montevideo Treaty that established the Latin American Free Trade Association (LAFTA).[6] While that treaty provided for the eventual creation of a Latin American Common Market, it initially envisaged only multilateral negotiation of regional tariff reductions and elimination of other barriers limiting the volume of intra-area trade. It contained no provisions for coordination of external commercial policy, and no practical rules for the harmonization of internal policies of member countries.

LAFTA established a transition period of 12 years during which member countries were to gradually eliminate most of their mutual trade barriers through product-by-product negotiations. Two tenets were to serve as guidelines for implementation of the agreement: the principle of reciprocity, and the "most favored nation" clause. Reciprocity allowed those members whose trade flows with the rest of the area did not increase, or became largely unbalanced, to request compensation.

The "most favored nation" clause is similar to the GATT principle, by which each member country should extend to all other members any tariff advantage granted to third countries (whether or not the third country is a party to the agreement). However, in accordance with the principle of reciprocity, member countries could grant some other members tariff reductions not extensive to the rest, provided that the beneficiary was a country with a relatively lower level of economic development. This discriminatory rule could have avoided extensive trade diversion, but the relatively less developed countries were never clearly delineated.

The Agreement was to be implemented through three negotiation mechanisms: the national lists, the common lists, and the agreements for industrial complementation. The national lists contained those products for which an individual member country agreed to reduce its tariff level by at least 8 per cent after each round of negotiations. The common lists were to be negotiated every three years in a multilateral forum and to include those commodities for which all the members, collectively, agreed to eliminate all internal trade restrictions over a formative period of 12 years. The agreements for industrial complementation were conceived as bilateral understandings between members of the region for the coordination of their industrial policies, the objective being to promote the production of commodities not yet subject to intraregional trade. These agreements were to be mainly bilateral, but any member could join in through negotiations.

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[6] The Montevideo Treaty was signed by Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay. In 1961, Ecuador and Colombia added their signature. Venezuela joined LAFTA in 1966 and Bolivia in 1967.

LAFTA's promise of steady progress toward elimination of trade barriers in the region was never fulfilled. Not even the short-term goal of establishing a free trade area by eliminating the tariffs on the common list was achieved. The national lists were of little practical importance and their enactment all but stopped when the Andean Group was created in 1969. Only one common list was approved in 1964 and never became effective. After 1969, the focus of negotiations in LAFTA shifted from trade issues to agreements for industrial complementation. However, these agreements covered very few sectors, and they were generally dominated by multinational corporations and mostly located in the three larger countries, Argentina, Brazil, and Mexico.

The standstill reached by LAFTA in 1969 and its decline thereafter are clearly reflected by the share of negotiated commodity trade in total intraregional trade. This percentage, which reached a peak of 88.7 percent in 1964–66, fell to 40 percent by the end of the 1970's.[7] In other words, intraregional imports not subject to LAFTA agreements grew faster than those that were negotiated and on which some type of tariff reduction had been reached. An even more striking fact is that imports subject to LAFTA agreements were no more than 6 percent of the total imports of the region from the rest of the world in 1979.

What are the main underlying reasons for the weakness of LAFTA? As its name indicates, LAFTA was designed as a framework for the partial reduction of the limitations to regional trade, and the original Treaty did reflect this pure "trade approach" to integration. It did not provide for any mechanism that would guarantee the even distribution of the costs and benefits for the potential increase in trade flows, nor instruments for the planning of multilateral investments in industries with a regional rather than national scope and for the harmonization of domestic monetary, fiscal, and exchange rate policies. The smaller countries in LAFTA were interested in advancing beyond the pure "trade approach" and sponsored the creation of instruments that would use the integration process as a framework for the implementation of collective development initiatives. Thus, in 1964 a resolution was approved establishing formal mechanisms for the programming of regional investments. However, this decision was never implemented.

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[7] Trade is measured by imports. The numerical information is from Kesman (1983).

Although some trade barriers were reduced in the middle 1960's, these reductions applied mainly to commodities that were already traded regionally and, consequently, the Treaty only consolidated and expanded traditional trade. This outcome meant less trade diversion, but it afforded little incentive for the continuation and deepening of the import-substitution process. In practice, particularly after 1964, most of the attempts to further reduce or eliminate tariffs were frustrated by sectorial opposition. Progress took place only when the interest of one member country in capturing the market of another did not affect any particular sector in that country.

The nature of the integration process as envisaged in LAFTA did not necessarily have to lead to confrontations of this type. Clearly, with the reduction in the level of protection some industries might not be able to compete in the new environment. However, a negotiated mutual liberalization of trade could in many cases avoid the total elimination of industries with higher costs, if some sort of intra-industry specialization could be assured. This liberalization requires each country to specialize, within each industry, in those varieties and qualities in which it has, or is likely to attain, a comparative advantage. Although a strong case for such specialization could be made, it is not easy, however, to determine which products would have a comparative advantage in a regional context and some degree of centralization in establishing patterns of industrial specialization may be more conducive to the attainment of an efficient structure. No mechanism for such centralization was created within the LAFTA framework. Moreover, the Treaty did not institute mechanisms designed to deal with issues arising from creation of new industries in response to an enlarged market. The geographical location of new industries is a crucial factor in determining the trade effects of a union. To the extent that new regional industries produce commodities previously originating outside the union, there will be export gains for the new producers but a traditional trade-diversion effect for the rest of the members. In those cases in which LAFTA led to the emergence of profit opportunities in new areas and thus of incentives to the creation of new industries, the determination of the location and structure of those industries was left to market forces, and no attempt was made to supervise the process. Since Argentina, Brazil, and Mexico were at a significantly higher level of industrial development than the rest of the members, free market force would have led to a concentration of new industries in those countries. The deepening of the integration process within an arrangement like LAFTA would have resulted in the reproduction, at the Latin American level, of the world pattern of trade, the more advanced countries reaping most of the benefits of industrial development, and the rest of the members concentrating on the production and export of primary commodities. Such a model of integration was rejected by the smaller countries and was a central reason for the stalling of the process.

An additional major limitation of LAFTA was the absence of provisions for harmonization of economic policies. Thus, each member continued to design exchange rate, fiscal, and monetary policies to serve its dometic needs, without coordination with other members and without regard for the stated objective of increasing cooperation within the region. In addition, since opportunities for a substantial expansion of extra-regional exports were not perceived, no attempts were made to collectively exploit possible externalities in the process of export promotion (i.e., developing common marketing strategies or exploiting common lines of credit). Moreover, in the absence of any agreement about a common policy for the treatment of foreign investment the creation of LAFTA offered large profit opportunities in a number of specific areas for foreign-owned firms that could take advantage of the larger market size by locating their operations in countries with more favorable treatment. This situation gave rise to distortions and trade diversion since the relocation of industries from one member country to another was due not to underlying economic factors but to different financial treatment of foreign investment.

### THE COMMON MARKET MODEL (THE ANDEAN GROUP)

The limitations and internal contradiction of interests in LAFTA led to complete paralysis of the process and convinced many members that a different type of integration model was required if integration was going to play a pivotal role in achieving sustained development through trade. For that reason, the Andean countries, which felt a stronger need to expand their markets than the larger countries in the region, decided to follow a different, more ambitious, pattern of integration. In 1969 they signed the Cartagena Agreement that formally created the Andean Group.[8] There was a marked desire among members to learn from the experience of LAFTA and to correct the shortcomings of that framework. The main operating procedures established by the Andean Group were the following:

(a) mutual trade liberalization within the subregion would be carefully planned at a global level;

(b) a common external tariff with the rest of the world would be gradually established;

(c) costs and benefits would be distributed mainly by the implementation of regional investment programs;

(d) efforts would be made to harmonize domestic economic policies, starting with the treatment of foreign investment; and

(e) special treatment would be given to the two relatively less developed countries in the area, Bolivia and Ecuador, which would be allowed to implement the agreements at a slower pace.

The prospects of the Andean Group were more promising in that its members had fewer structural dissimilarities and fewer conflicts of interests. Moreover, frictions would be minimized through more global and automatic negotiations instead of item-by-item negotiations as in LAFTA. However, the adoption of a common external tariff and subregional industrial development planning proved more difficult than originally thought. In addition, some problems were not fully addressed and remained, as in LAFTA, obstacles to sustained progress. They included the lack of a mechanism for aligning the exchange rate policies of individual countries with subregional liberalization policies and ensuring coordination of their export promotion strategies. The issue of intra-regional factor mobility was almost totally disregarded.

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[8] The original signatories of the Agreement were Bolivia, Chile, Colombia, Ecuador, and Peru. In 1973, Venezuela joined the agreement while in 1976 Chile decided to leave it.

The establishment of a common external tariff and adoption of a subregional program of industrial planning, two innovations of the Andean Group, require some detailed analysis of the problems they involve. Both instruments are appropriate means of dealing with the issues of policy harmonization and the distribution of costs and benefits the problems they raised proved extremely difficult given the significant conflicts of interest between the accepted common objectives and the basic development strategies of the individual countries. A successful integration process requires more than an understanding about harmonization of policies, since the implementation of such policies will face unsurmountable difficulties as long as there are serious discrepancies among the members about their long-term development strategies.

A case in point is the complications arising from the process of specifying the common external tariff.[9] The plan to establish a common external tariff by 1980, by which time the level of intra-region tariffs for a long list of commodities should have been reduced to zero. This plan was not fully implemented for a number of reasons. The commercial policy envisaged by the Agreement is equivalent to the grant of an implicit subsidy to domestic and subregional production. The subsidy arises from the margin of preference implied by the tariff, which does not discriminate between domestic and regional production but establishes a common discrimination between the region and the rest of the world. Adoption of this policy requires the countries to surrender their autonomy in a number of areas, since the spirit of the Agreement would not be served if exchange policies, indirect taxation, and non-tariff barriers are not subject to coordination, and thus carries political and economic costs.

The economic cost may be substantial if, prior to the establishment of the tariff, the volume of intra-regional trade was limited, because the common external tariff leads to significant trade diversion.[10] To be acceptable, the cost arising from the higher priced imports must be compensated by increased access to an enlarged export market. Since the potential of individual countries for expanding industrial exports varied greatly, a serious distributive problem was bound to arise. Thus, the adoption of a common external tariff, together with the elimination of internal barriers, may result in an intra-regional transfer of income whose magnitude depends on the level and the dispersion of the common tariff. The higher the common tariff, the higher the potential internal redistribution if the level of the tariff is assumed to reflect the cost differential between the world price and that of the most efficient regional producer. In the absence of a comprehensive compensation policy, the level and coverage of the common tariff becomes a matter of serious contention. In the presence of compensation, its size and the mechanism for its implementation become difficult issues.

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[9] For a detailed discussion of this issue, see, for example, Schydlowsky (1978) and Morales (1983).

[10] Assuming that there was some trade with the rest of the world in the commodities in question before the formation of the union.

An additional source of trouble is the interrelationship between commercial and exchange rate policies. Intra- and extra-regional competitiveness is jointly determined by the tariff and exchange rate levels. When a country devalues its currency, it increases the level of protection granted by a given common tariff and its incentives for intra-regional exports. On the other hand, a country with an overvalued currency will want a higher common external tariff to preserve its internal market and restrict external competition for its exports to other countries of the region. This conflict is exacerbated when countries in the region do not share the same outlook about the role of the external sector in the development process. Thus, in the discussions in the Board [11] there were two opposite positions: Colombia (joined later by Bolivia and Peru) favored a lower external tariff, mainly for efficiency reasons and because of its more export-oriented strategy and its policy of maintaining a realistic exchange rate for its manufacturing sector. Chile actually broke with the Group over its insistence, basically guided by a free-trade ideology, that external barriers should be uniform and minimal. On the other hand, Venezuela insisted on a high common tariff because it wished to compensate for the large productivity gap between its petroleum sector, which determines its exchange rate, and other sectors of the economy.

Another difficulty is the different degree of preference various member countries wish to grant to their industrial sectors relative to their primary sectors. Since it is widely believed that the relative productivity and competitiveness of primary sectors in export markets is higher than those of industrial sectors and that industrial sectors need protection if they are to reach similar levels, it has been repeatedly argued that discrimination is required in the treatment of the two sectors. This argument is the basis of what has been called "the dual tariff-exchange system," which demands a higher effective exchange rate for the industrial value added than for the agricultural or mining value added.[12] The problem, within the integration framework, arises when the member countries take different positions on the relative degree of protection that they want to grant their industrial sectors vis-a-vis their traditional sectors. If the various members have different views regarding their long-run development paths, they will probably wish to discriminate between their two sectors with different rates for the common external tariff. The adoption of a common external tariff, which applies almost exclusively to industrial commodities, will reduce the freedom of the members to protect their industrial sector.

The second innovative element in the Andean Group is the role of industrial planning in trying to solve the location problem and to further import substitution at a regional level. The objective is to maximize the benefits, for the Group as a whole, of establishing new industries, and at the same time, to distribute those benefits equitably. These two objectives may not be consistent since maximization of benefits presupposes the full exploitation of intra-regional comparative advantage, which may not satisfy regional equity considerations. In addition, industrial planning is biased in favor of producers and disregards the implied costs for consumers and the distribution of those costs. If those costs are unevenly distributed, pressures to stall such planning are certain to mount.[13]

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[11] The Board of the Cartagena Agreement functions as the Secretariat of the Andean Group.

[12] This can be done by means of a unified exchange rate determined by the primary sector coupled with tariffs and subsidies in the industrial sector, or by means of a dual exchange rate system. If a single exchange rate, determined by the industrial sector, is adopted, discrimination requires the use of export taxes in the traditional sector.

The potential conflict between efficiency and distributive equity may threaten the viability of industrial planning. It may be argued that to ensure a more equitable distribution of costs and benefits from integration, the efficiency criterion should be eschewed in favor of higher intra-regional equality. But such a policy could mean very high costs and a waste of resources, and therefore, mechanisms that allow the separation of location from ownership may be more appropriate. The new industry could be owned by multinational corporations formed by all member countries, the distribution of dividends being linked to the level of benefits and to some agreed criteria for distributing them equitably.[14]

Two additional difficulties are the delegation of authority to a multinational entity and labor mobility. With the first, if the long-term development approaches of the members do not coincide, the sectoral priorities of the national development strategies may clash with those of regional industrial planning. The acceptance of the principles underlying the regional programs implies the submission of national planning to more global considerations, and thus it also implies the surrender, at least in part, of power to determine the patterns and characteristics of industrial development. The long-term implications of these considerations make the surrender of power in this area politically impossible.

With respect to factor mobility, the issues of labor migrations and capital flows were never settled within the Andean Group. Different levels of labor utilization and wages have implications for the integration process. Without labor mobility, the difference between the social and the private cost of labor will tend to vary in each member country and, as a consequence, the social cost of producing the same commodity will differ, even if the private costs are equalized across countries. This difference will create additional difficulties in the design of common policies since, for example, the equalization of social costs will require different external tariffs,[15] which is incompatible with the principles of a common market.[16]

Another important element in the negotiation of common policies in the Andean Group was the approval of the Andean Foreign Investment Code (Decision 24), which covers the treatment of direct foreign investment and technology transfer. Given the restrictive nature of the decision, the possible negative effects it might have on the flow of foreign capital to the Andean nations was the subject of a considerable discussion. Among its most controversial aspects were the obligation of foreign-owned businesses to become national or mixed enterprises if they wished to exploit the expanded Andean market and the prohibition of the acquisition of domestically-owned businesses by foreigners. Recent econometric evidence shows, however, that the Code caused no significant change in direct foreign investment to the Andean Group relative to other Latin American countries.[17]

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[13] For a discussion of this issue as well as the compatibility of domestic with regional objectives, see Thoumi (1976).

[14] See Schydlowsky (1978).

[15] Because the equalization of social costs requires a differential between the private costs (and prices) of the various countries.

[16] While the discussion in the text refers to the lack of labor mobility, the same difficulty applies to other factors of production, including capital, whose movement within the region was also restricted.

### A LOOSE ARRANGEMENT MODEL [LAIA]

With the stagnation of LAFTA and the more comprehensive arrangements reached within the Andean Group, there was a feeling in the rest of Latin America that the formal framework of integration should be reshaped. Against this background, a new organizational structure, the Latin American Integration Association (LAIA), was created in 1980 to replace LAFTA. Although with high aspirations for the long run, the new organization is in fact a much looser framework with a smaller scope than LAFTA. The two basic instruments of LAIA are negotiated partial agreements and regional tariff preferences. The partial agreements cover bilateral tariff reductions and contain a "convergency" clause that allows other members to negotiate their inclusion in the agreements. The regional tariff preferences are limited reductions in the external tariff of each member and apply to all the members of the Association. These preferences do not constitute a common lower tariff since each country maintains the level of its tariff with third countries but grants a specific preference to the other countries of the region. Members therefore have perferential access, relative to the rest of the world, to the markets of other members, but intra-regional tariffs continue to differ for the same commodities.

Thus, with the establishment of LAIA, the global program of regional liberalization which characterized LAFTA, is replaced by a formal arrangement aimed at setting up an area of partial economic preferences. Although this shift implies a weaker commitment of the non-Andean countries to the idea of economic integration, it is also a reflection of a more realistic and pragmatic attitude. In LAIA, trade negotiations are bilateral, particularly since the abandonment of the most-favored-nation clause, the centerpiece of LAFTA, makes generalizing preferences a non-binding but a negotiated process. It, therefore, facilitates the conclusion of agreements between countries with some common interests that may not be shared by the rest of the countries of the area. This approach may make for increased intra-regional trade flows and thus an environment more conducive to regional cooperation in other areas. In addition, bilateral agreements may be concluded by countries that already have trade relations, which would increase the potential for trade creation and reduce the risk of trade diversion.

The regional tariff preferences may be a source of contention. If a united tariff for intra-association trade is not adopted, the access each country grants to the other members may vary sharply. If, for example, the tariff of country A is unnecessarily high while the tariff of country B is very low, the same margain of preference may still deny regional access to the market of A, while entry into the market of B may be free for member countries. This difference is bound to create friction and will limit the number of agreed tariff perferences.[18]

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[17] See Aho and Núñez del Arco (N.D.).

## PART III. RECENT DEVELOPMENTS, OPTIONS, AND THE OUTLOOK FOR REGIONAL COOPERATION

This section is devoted to an appraisal of two very different, although not fully independent, set of questions. The first is the impact of recent world and regional developments on the process of integration, and the second, the options for broadening, formally or informally, the concept of economic integration to include other forms of regional cooperation.

A number of significant developments in the global environment and the regional economic scene during the past decade have affected the objective conditions, as well as the socio-political milieu, in which the process of integration has evolved in Latin America. The most consequential are: (a) the differential impact on the region of the 1970 oil shocks; (b) the adoption by some of the countries of comprehensive trade liberalization programs inspired by a free-market ideology; and (c) the world financial crisis, whose center is the unprecedented volume of Latin American foreign debt.

### THE OIL SHOCKS

While the 1973 and 1979 oil shocks has had a global or generalized effect on the Latin American economies, it has also had a marked differential impact on various countries of the region. The major global effects arise from the serious economic recessions in many industrial countries which spread to the periphery, with the downturn in the growth of international trade and the deterioration in the prices of primary commodities other than oil. For the less developed countries (LDCs), the expansion of exports to industrial countries, which had been a source of growth, slowed. In these circumstances, a deepening of the integration process could have served as a palliative, and offset the effects of the reduction in external demand. Moreover, since installed capacity was idle, owing to the spread of the external-sector induced recession, the social cost of trade diversion—certain to arise from regional tariff reductions—would have been very low or nil.

More important still, in many industrial countries the [pre-1985-86] oil crisis can be regarded as the cause of the "new protectionism." This trend, characterized by a proclivity to institute an increasing number of explicit and implicit trade barriers, essentially to protect domestic employment, should have had centripetal effects in LDCs, and have strengthened cooperation and integration. Increased regional cooperation could have had the double objective of compensating for the loss of external markets and of acquiring bargaining power for reversing, or at least arresting, the drift towards economic isolationism in the industrial countries.

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[18] In addition to preferential margins, LAIA requests all members to eliminate non-tariff restrictions on intra-regional trade. This request has been fulfilled to a very limited extent.

That such a worldwide deterioration in economic conditions did not intensify integration efforts within the existing formal frameworks, could be at least partially explained by the differential incidence of the oil crisis on the various countries of the area, which depended on their relative position in the world oil market. Oil exporters, particularly Venezuela and later Ecuador and Mexico, strengthened their external payments position while oil importers, like Brazil and most of the Central American countries, saw their external balance deteriorate sharply. This change in the internal distribution and in the value of the countries' endowments was instrumental in making the set of common goals established by the integration frameworks less achievable. A clear expression of this new reality was the changing priorities of the members, which was evidenced by the increasing divergence of their development strategies.

The oil exporters tried to use their windfall gains to assure their long-term growth through heavy infrastructure investments; other countries, aware of their potential, sought to become energy self-sufficient; and another group of countries had to adjust its strategy to cope with the imbalance created by the need to rely, even in the long run, on large amounts of imported oil. A practical consequence of this situation was the adoption of exchange rate and fiscal policies, as well as of many types of domestic incentives, designed to achieve new priorities, even though those policies were detrimental to, or at least inconsistent with, the attainment of regional objectives and the aims of the integration process.[19]

The substantial change in the relative price of energy had serious consequences for the viability of some operational aspects of the integration agreements already established. As mentioned above, the development approach to economic integration requires regional specialization to follow the principle of long-run internal comparative advantage. In practice, particularly within the Andean Group, this principle was to determine the location of new industry. However, the energy shock may have changed the pattern of internal comparative advantage and altered the considerations that guided the establishment of new industries. Furthermore, the changes in regional income distribution were bound to affect the distribution of gains and losses from the process in general and from industrial planning in particular. It is therefore safe to assert that, in the wake of the oil shocks, criteria for the reallocation of resources and for subregional specialization needed to be reassessed, which has been an important reason for the slowdown in the process of integration since the late 1970's.

### LIBERALIZATION POLICIES

A second salient event of the past decade was the adoption of comprehensive trade-liberalization programs in the Southern Cone countries of the region (Argentina, Chile, and Uruguay). In other countries, existing liberalization plans were expanded and, in general, there was a growing disposition in many areas of the region to turn away from protectionism and to allow free trade to play a large role in the economy.

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[19] The first oil shock coincided with a commodity boom, which improved the terms of trade of some countries of the region and reduced their perceived need for integration as the centerpiece of their development strategy.

The Southern Cone countries concentrated their efforts on introducing far-reaching trade and financial reforms based on deregulation and on the opening up of the economy to external forces. However, these reforms were introduced during a period of extreme external and internal disequilibrium in those countries and therefore the adoption of liberalization policies was accompanied by the implementation of comprehensive stabilization plans. Although both sets of policies interact, they were designed to attain quite different sets of objectives; the opening up of the economy was not, in principle, an instrument of cyclical adjustment but rather an attempt to change the basic economic structure. The stated purpose of the new trade policy was to open the economy to foreign competition by reducing and standardizing tariffs and other foreign-trade restrictions, and by easing the limitations on foreign investments and foreign credit. This policy marked the abandonment of import substitution and the adoption of a development strategy based on the gains from trade. As a result of foreign competition, the economy would be able to eliminate distortions and improve productivity and the allocation of resources, which would lead to a sustained acceleration in economic growth.

The application of these policies, and the widespread appeal of the approach to other countries of the area, had a number of consequences for the integration process. At the operational level, contradictions appeared between the liberalization policies and the contractual obligations entered into by some of the countries in the framework of the existing integration systems. The most dramatic event in this context was the conflict between Chile and the Andean Group. In October 1976, tariff reforms, as well as a new liberal treatment of direct foreign investment, led Chile to abandon the Andean Group and to pursue independent trade and investment policies.[20]

In addition, the liberalization attempts coincided with a period of innovation, on the one hand, and of turbulence, on the other, in the foreign exchange markets of many countries. Some of the policies adopted—for example, use of the exchange rate as a counterinflationary mechanism, preannouncement and lagging of the rate of nominal devaluations, refusal to adjust the rate in the face of drastic terms-of-trade variations, and other measures that disturbed the role of the exchange market as an equilibrating mechanism—produced wide fluctuations in the value of the real exchange rate and dramatic swings in the direction of intra-regional trade. They occurred because profit opportunities constantly shifted across borders and were generally perceived as unsustainable and, therefore, only short term in nature. In addition to payment imbalances, this situation created confusion and turmoil in the trade relations of the countries involved, unsettling regular commercial ties, and disturbing the conventional mechanisms that affect the nature of trade flows. The exchange disarray that arose from nominal and real exchange rate fluctuations dislocated the structure of regional trade. It also shifted attention away from the factors underlying trade patterns (such as comparative advantage, productivity, and endowments) to financial and monetary short-run developments. This turn of events disturbed the integration process by weakening the concept of unified regional markets and lowered the likelihood that any sort of exchange rate policy coordination could be attained.

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[20] The source of the conflicts was the opposition of Chile to the common external tariff and the Andean Foreign Investment Code.

However, the advent of liberalism to the region hindered the process of integration most at the doctrinal level, since it gave renewed impetus to the debate about the adequacy of the development model upon which integration was based. As already discussed, integration in Latin America was conceived as an essentially inward-looking process, an extension, within an enlarged setting, of the post-war pattern of development based on import substitution and the preservation of the domestic market for local producers.[21] The liberalism that became popular in the mid-1970's opposed the continuation of import substitution, which it regarded as exhausted and, even worse, as a source of distortions, inefficiencies, and misallocation. Liberalization, on the other hand, was advocated as an outward-looking approach designed to exploit the advantages of a small country in the world economy and to foster competition efficiency, and modernization. As such it was, in some sense, the antithesis of the theory upon which integration was based since it advocates low and non-discriminatory tariffs and more reliance on the free market mechanism for the allocation of resources.

However, integration and liberalization are not intrinsically irreconcilable concepts. In fact, if the argument for integration is based on grounds like the infant-industry thesis, protection is only justified temporarily, and export promotion and liberalization policies, albeit regionally coordinated, can be regarded as eventual phases of the process. The conflicting ideologies certainly had a detrimental effect on the integration process. But, again, the main stumbling blocks to the process of integration are not the product of conflicting interests in rather limited specific issues, but fundamental differences of opinion about long-term development strategies.

Nevertheless, the process itself did not suffer a fatal blow, largely because of the apparent failure of the liberalization attempt. For a diversity of largely country-specific reasons, most of the countries were forced to abandon the reform packages that included the opening up of their economies as a centerpiece. Although the free trade policies adopted are not to be blamed for the collapse of the programs (Blejer, 1983), the demise of liberalization in the early 1980's reversed the trend against economic integration as a leading development strategy. The emerging negative attitude to liberalization was strengthened by the bad timing of the Southern Cone experiment, which coincided with intensification of protectionist tendencies in industrial countries. These tendencies reinforced parallel trends in the developing world and restored respectability to protectionist policies as a desirable option, and thus reestablished the ideological viability of the Latin American integration movement.

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[21] This approach is not very different from that of the European Common Market to the agricultural sector. In fact, it could be argued that there is more merit in protecting industry in developing countries than in protecting agriculture in Europe, which can only look to a declining future. There is, therefore no normative implication in the assertion here about the protectionist characteristics of the integration process in Latin America.

### THE FINANCIAL CRISIS

The third global development that may affect the prospects of the integration process is the large accumulation of foreign debt by most Latin American nations. Whatever the particular circumstances in each country that led to unprecedented stocks of foreign liabilities, the common denominator in the region is the drastic reduction in available foreign financing and the need to curtail domestic expenditures in order to generate trade surpluses for servicing the foreign debt. The adjustment programs implemented in many countries tend to reduce economic activity and growth, and thus to induce balance-of-trade improvements largely because of contraction in the volume of imports. Although some impressive balance-of-trade surpluses were achieved in 1983, the sustainability of the programs and the feasibility of maintaining surpluses of that magnitude over long periods of time are open to question. A large portion of the surpluses is generated by import cuts, and there are only a few signs that non-traditional exports are expanding enough to play a significant role. The current adjustment, therefore, clearly tends to depress trade, which has a number of consequences for intra-regional commercial relations.

In the first place, the contraction of intra-regional trade has been proportionally larger than the overall trade reductions. If this contraction represents only reciprocal cuts in imports, it will certainly not produce foreign exchange savings for the region as a whole. On the other hand, the mere promotion of intra-regional exports growth will not, *per se*, generate additional hard currency for servicing the foreign debt. The contention that economic integration should be stepped up as a response and as a solution to the foreign debt problem is valid only if intra-regional exports substitute imports from outside the region. In such a case, foreign exchange may be saved for the region as a whole, but a difficulty arises from the fact that, by definition, this substitution implies trade diversion. Moreover, the source of such additional intra-regional exports has to be clarified. If it is a simple redirection of exports away from extra-regional destinations, no additional foreign exchange is gained. If, on the other hand, exports are produced from resources drawn from the non-traded sector or, more important, if idle resources are utilized, there is a net gain of foreign exchange for the region as a whole. In the case of intersectoral factor mobility, the welfare cost of trade diversion still persists, but it intra-regional export growth generates employment, trade diversion has a very low social cost and there is a genuine gain for the region as a whole. In sum, the intensification of integration can play a role in the solution of the debt problem, provided it is export oriented and can mobilize idle capacity and resources without diverting those already used in extra-regional exports.

## OPTIONS FOR FURTHER COOPERATION

In view of the experience of recent years, a discussion of additional mechanisms that could consolidate the process of integration within its formal structure and further promote regional cooperation in areas other than the already established formal frameworks is in order. One area that deserves attention is the integration of financial markets. This integration is one of the most advanced stages of the process and usually takes the form of a monetary union. Such a union involves the establishment of fixed exchange rates between the currencies of the member countries and the harmonization of monetary and fiscal policies. Although this integration does not represent an actual forfeiture by individual nations of their right to design their domestic economic policy, it certainly requires a high degree of policy synchronization and normally presupposes the existence of a customs union before a monetary union can be established. Moreover, the free movement of goods, services, and factors of production is a necessary pre-requisite for a successful monetary union.

Given the slow progress of the integration movement in Latin America, advocacy of any type of monetary integration would be inappropriate. Moreover, considering the different patterns of production, the small share of regional trade as a proportion of total trade, and the relative immobility of factors of production, the region certainly does not meet the optimality criterion for the establishment of a common currency area (Mundell, 1961). However, this situation should not prevent the pursuit of some type of coordinated management of exchange rates and the promotion of cooperation agreements in the financial area.[22]

It is quite remarkable that, unlike what has happened in the commercial area, little interest and effort has been devoted to the promotion of mutual understanding in the area of invisible trade in general, and in financial services in particular. Modern trade is making increasingly intensive use of financial, information, communications, and other types of services, which are playing an important role in the development of trade relations and in the determination of the directions of trade flows. To some extent, goods entering world trade can be regarded as composite commodities, composed of the goods themselves and the services that took part in transferring them from producers to the foreign consumer. Although some theories consider the service component a non-traded commodity, many items, particularly in the financial area (such as insurance, banking, credit information, etc.) are increasingly becoming subject to international trade. For this reason, the pattern of comparative advantage may be determined not only by the relative costs of producing the commodities themselves but also by the composite cost of bringing them to the world market.

Although it would be difficult to argue that developing countries have any obvious competitive edge in the provision of financial and other trade-related services, economies of scale in the provision of these services are likely and, therefore, regional sharing and other cooperative agrements in this field could produce lower financial and other service costs throughout the region. The outcome could be both an intensification of existing trade flows and a re-direction of trade from outside the region due to a more competitive position of the member countries when an all-inclusive measure of the cost of trading is considered. In other words, imports may be cheaper from inside the region than from outside when financial and other service costs are included, if agreements on reducing those costs for intraregional trade are reached.

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[22] The financial organ of the Central American Common Market (CACM), the Central American Monetary Council, was very active in coordianting policies in this area. However, during the 1960's all the Central American countries maintained rigidly fixed parities with the dollar.

Many cooperation mechanisms could reduce trade-related service costs. They include the collective provision of insurance services, non-discrimination against the commercial banks of other countries in the region, incentives for the operation of regional banks for the provision of trade services, the promotion of specialized credit lines, and the pooling of marketing and advertising information. However, most of the relevant instruments will not operate efficiently without some degree of financial-market integration. Although free mobility of factors is an advanced stage of the process of economic integration, and many countries in the region have resorted to nonconvertibility and restrictive foreign-exchange practices, it is still plausible to argue for the granting of preferential treatment for intraregional capital flows, even if limited to specific uses. It would be hard to conceive of the internationalization of freight insurance services, for example, or the regulation of banking practices, which could bring substantial savings in trade operations, without some degree of capital market integration. Thus, the opening up of the financial systems of the region could conduce to an intensification of trade relations and the strengthening of commercial integration.[23]

An area that offers particular promise for the strengthening of cooperation is the formalization of the "de facto" integration arrangements that have arisen over the years, particularly in border areas. The absence of transportation and communications costs means that profit opportunities arising on either side of the border will tend to be quickly subject to arbitrage. The result is mutual dependence and a set of interrelationships that can help deepen the formal integration of the complete economies.

## PART IV. CONCLUDING REMARKS

In this overview, the main analytical considerations upon which the theory of economic integration is founded have been examined, and the directions in which the basic framework was extended in order to take into account the specific conditions of developing nations have been described. It is argued that the main focus of the "development approach" to integration has been to rationalize the extension of the use of protectionist policies beyond national boundaries.

Economic integration in Latin America and the evolution of various frameworks were considered, and the main stumbling blocks analyzed. Clearly, the Latin American process was largely based on the "development approach", which relies on protection to enlarge the size of the market, attain economies of scale and, through a learning process, gain the dynamic benefits arising from increased productivity. In fact, most countries viewed integration merely as a means of continuing the import-substitution process. They considered the potential larger market as a means of overcoming the limitations imposed by technology and by indivisibilities in plant size when import substitution is deepened beyond the final and the intermediate goods level.

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[23] Another potential area for increased cooperation is financial-market taxation. Differential taxation gives rise to abnormal patterns of capital flows, which may distort trade patterns, particularly if they generate under- and over-invoicing intended to avoid exchange controls.

The quite limited objective of encouraging regional trade, without cooperation in other areas, was, to a large extent, not achieved by LAFTA, the first formal attempt to integrate the region. Barriers to intra-regional trade fell slowly and the process eventually reached a complete standstill. More successful in this respect were subregional arrangements such as the Andean Group and the Central American Common Market. The Andean Group's attempt to use industrial planning to deal with the problem of distribution of benefits and to harmonize policies for extra-regional trade and foreign investments are examples of the broader scope of the scheme. However, in practice these mechanisms encountered immense difficulties. Conflicts of views and interests delayed or halted the implementation of the industrial plans and of the common external tariff, and very few other measures of policy coordination were actually put into practice.

Although it is possible to point to a number of specific issues as the source of the problems, it is the lack of agreement about long-term development strategies that has been the most important stumbling block in the process. Countries find it extremely difficult to relinquish, even partially, their national interests in favor of global interests when there are major disagreements about the desired long-run path for their economies. It is, therefore, difficult to envisage the successful integration of countries with conflicting views about the social, political, and economic characteristics of economic growth. Moreover, we have stressed the importance of policy harmonization in any integration framework, but experience shows that, to some extent, the harmonization of policies is a precondition for success and not an additional stage in the process.

The divergency of views about the nature of economic development may have been widened by such recent world and regional events as the oil shocks, the free-market experiences, and the emergence of foreign debt as a limiting financial factor. This situation may impose additional restrictions on the process of formal integration. However, these events should have strengthened the need for regional understanding. A feasible path to follow is the encouragement of cooperation in many areas outside the formal integration frameworks. Regional trade would tend to prosper if countries could provide a stable environment for an intensification of mutual relations. The search for stability includes the affirmation and clarification of the rules to be observed in policies governing all types of regional relations and transactions. Such rules are necessary if there is to be a reduction in the uncertainty that hampers those transactions and prevents related cross-country investments. A clarification of the rules that apply and a realistic appraisal of the costs and benefits are crucial elements because the progress of integration cannot be assured unless each country is certain that there is a just distribution of benefits, that the rules are feasible, and that other countries are observing them.

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## DOMESTIC POLICY

# THE DEBATE ON STABILIZATION POLICY IN LATIN AMERICA

By Edmund J. Sheehey

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## SUMMARY

A serious handicap in dealing with the inflation and balance of payments problems of the major Latin American debtor countries is the lack of a consensus on the ingredients of an effective and politically viable stabilization program. Orthodox or monetarist economists continue to see the problem as one of excess demand to be dealt with by devaluation and contractionary fiscal and monetary policies. In some recent instances these policies have been applied together with greater reliance on free markets, in part by opening the economy to greater trade and capital flows.

Another school of thought, the structuralists, argues that these orthodox policies, because they ignore structural characteristics arising from institutional and behavioral differences, will often produce outcomes opposite to those intended. The structuralists advocate stabilization programs which, while aiming to eliminate structural distortions over the longer-term, in the short term combine a more gradual application of the standard policies with market intervention by government.

## INTRODUCTION

Economic stabilization policies in developing countries aim to correct the problems of excessive balance-of-payments deficits and high domestic inflation which have been especially prevalent over the past decade. A country usually undertakes a stabilization program in conjunction with the International Monetary Fund whereby a standby loan is extended with attached policy performance conditions. With a number of Latin American countries unable to meet their debt servicing obligations to international lenders in the 1980's, stabilization programs under the auspices of the IMF have been a preliminary requirement for debt rescheduling by lenders.

While a modest economic recovery in Latin American during 1984 fed hopes for successful stabilizing programs in the 1980's, hopes based on these short-term developments need to be tempered by the spotty performance of stabilization experiences in Latin America. Good short-term performance in dealing with instability has usually been followed by another, often more serious, period of disequilibrium.[1] The large debt burden now faced by most Latin American countries cannot be reduced to manageable proportions with one or two years of contractionary policies but will require tight economic management that achieves both growth and stability through the decade. With the return of democratic governments in many South American countries, such management will require a consensus about how stabilization is to be achieved and how its burdens are to be distributed. To maintain broad social support, Latin America needs an approach to stabilization that is consistent with steady, though not necessarily immediate, expansion and that brings tangible gains for the main social groups. Unfortunately, how to achieve such a stabilization program in practice is a source of deep controversy both in Latin America and elsewhere.

The purpose of this paper is to examine this debate and sort out the economic thinking behind the various positions. The debate is a spirited revival of a long-standing controversy about macroeconomic policy in Latin America, that of structuralism versus the more orthodox monetary policies termed by Latin Americans as "monetarism." While the key participants do not necessarily see themselves as marching closely in step under these two competing banners, the two labels remain appropriate. The monetarist approach as advocated by the IMF[2] is still based on fiscal and monetary restraint. For them, the content of macroeconomics does not vary across countries—the economies of developed and developing countries work is essentially the same way, and the same mainstream economic theory worked out in the industrial countries can, with relatively minor modifications, be used to solve the problems of developing countries. What is new with monetarism in the current debate is the effort to achieve a closer integration of the domestic economies of the lesser developed countries with the international economy and the attempt to radically restructure some countries along free market lines.

Structuralism exists largely as a reaction to the zeal of the monetarists. the basic tenet of the structuralists continues to be that monetarism does not work. Because of certain structural characteristics peculiar to developing countries, the macroeconomic policy outcomes which (are believed to) occur in industrial countries cannot be replicated in the developing world. What is different in the current round of the debate is that the structuralists' critique is now more extensive and is made at a higher level of economic sophistication.[3]

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[1] The stop-go cycle of stabilization policy in Latin America is well described in Diaz Alejandro.

[2] The analytical framework underlying the IMF's approach to stabilization is described in Buira.

This intense debate has generated a literature far greater than can receive justice in a single paper.[4] This treatment presents the view of each position rather than analyzing a large number of stabilization programs. Section two gives the historical background to the debate, section three details the current monetarist position, and the fourth presents the structuralist critique. Section five focuses the debate on a particular stabilization program in Peru and section six outlines the structuralists' recommendations for stabilization policy. A conclusion follows.

## THE STABILIZATION DEBATE OF THE 1950'S AND 1960'S

Only a handful of Latin American countries—Argentina, Bolivia, Chile, Brazil, and Uruguay—experienced high inflation and balance of payments problems in the 1950's. Early stabilization efforts, carried out under the auspices of the IMF, generally followed orthodox or "monetarist" policies that relied on the use of traditional monetary weapons. Inflation was diagnosed as a problem of excesive domestic demand stimulated by rapid money supply growth and a lack of budgetary discipline. Slowing growth of demand required a reduction in money supply growth and a return to reliance on market principles. Slower money growth was achieved by cutting central bank credit, particularly to government. Return to market principles included: (1) devaluing to eliminate gains in purchasing power enjoyed by the domestic currency because of higher domestic than world inflation; and (2) reducing government interference in markets by ending price controls, eliminating subsidies to producers and consumers, and removing currency and trade restrictions. Control of the money supply and greater reliance on the price mechanism were expected by themselves to generate an efficient pattern of investment, trade, and resource allocation that would produce steady output and employment growth without large balance of payments deficits.[5]

This view of stabilization was dominant not only because of the powerful position of the IMF and its orthodox policies, but also because of the lack of a practicable alternative. The structuralist school, centered in the UN Economic Commission for Latin America, attempted to provide an alternative based largely on the experience of Latin America. According to this school, the history of Latin American development has produced certain structural differences or rigidities that have prevented their economies from functioning like those of industrial countries. Structural imbalances render the equilibrating mechanisms of the price system inoperable so that production does not automatically respond to higher prices. As growth proceeds, bottlenecks develop in the supply of food products, availability of foreign exchange and domestic savings, supply of intermediate inputs, and the tax and expenditure structure of government, including wage pressure from organized labor.[6] The structuralists contend that, under conditions such as these, inflation is not an excess demand phenomenon, but is imbedded in an economic structure that lacks an adequate supply response. While some went so far as to question the link between rapid money growth and inflation, the point was that even normal growth would be inflationary. Not only would modest growth of output push up prices in food and other bottleneck sectors, but export growth would remain sluggish and unresponsive, producing balance of payments crises that would require devaluations and put further pressure on prices.[7]

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[3] For a highly analytical statement of recent structuralist economics, see Taylor (1983). See, also, Dell for a sweeping critique of traditional stabilization policies as imposed by the IMF.

[4] See the bibliography in Taylor (1983).

[5] The orthodox approach to stabilization policy as it was applied in the 1950's and 1960s is outlined in Eshag and Thorp.

For the structuralists, policy had to deal first with these underlying supply imbalances. In their view, when widespread bottlenecks exist and inflation is attacked by demand management policies, disequilibria are created in the form of excess capacity, unemployment, and concentration of income. Resulting social and political pressures force an end to the policy of demand restraint.

The crux of the debate, however, was over the underlying causes and persistence of structural factors. For the structuralists, uneven economic development and the resulting structural rigidities have been built in over a long period and thus require a gradualist approach to stabilization. For example, the unresponsiveness of agricultural production to higher prices is due largely to the particular evolution of land tenure in Latin America, according to the structuralists.[8] Monetarists counter that defective patterns of land tenure are largely the result of government interference in markets through tax and price control policies. Agricultural production lags not so much because of the impact of the Spanish colonial heritage on land tenure but because government has reduced the profitability of farming. The reform needed is not a larger role for government in overseeing the redistribution of resources to bottleneck sectors but a freeing of markets for the inputs and outputs of these sectors.

The structuralist approach of the 1950's and 1960's was at least plausible and found a large following, but it failed to provide satisfactory explanation of how these bottlenecks arose or how policy could realistically overcome them. In particular, when it came to the formulation of short-term stabilization policy in the face of a crisis, the structuralists lacked a coherent alternative to the orthodox approach.[9]

## THE NEW MONETARIST ORTHODOXY

In the 1970's, inflation and balance of payments problems beset most of the developing countries, and economic stabilization became a central policy issue. In contrast to the unprecedented boom in the international economy during the 1960's, developing countries in the 1970's had to adjust to the dollar crisis of 1971 and fluctuating exchange rates, a quadrupling of oil prices in 1973–74 that spurred high world inflation and recession in the industrialized countries that restricted export growth. The stabilization policies of the 1970's in Latin America combined standard macropolicies with, in some instances, a far-reaching attempt to fashion an open economy closely wedded to the free market. Moreover, it was increasingly alleged that successful implementation of orthodox policies required the authoritarian governments found in Latin America in the 1970's.[10]

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[6] A well known, early statement of these structural differences is contained in Sunkel.

[7] The monetarist and structuralist views on the link between structure and inflation were debated by Felix and Campos.

[8] The history of this system (latifundio-minfundio) is described in Furtado, Ch. 7.

[9] This point is made in the introductory chapter in Thorp and Whitehead.

The essentials remained the same: devaluation, restrictions on the growth of credit, and the lifting of price controls as first steps toward achieving a market-oriented economy. What was new in the 1970's were the sweeping reforms designed to open up the domestic economy to international trade and capital flows. Basic reforms included more competitive domestic financial markets, reduction in import protection, and the use of the exchange rate as a tool for fighting inflation.[11]

That stabilization programs adopted some of these elements reflects three not necessarily related developments. For one, given the shocks in the international economy, trade and financial reforms were long overdue and had been widely urged. A long literature had developed documenting the costs of trade and financial restrictions for developing countries.[12] On the trade side, the strategy of import substitution advocated by ECLA had shifted resources from the more competitive primary and manufacturing export sectors to less efficient higher cost manufacturing sectors which could only exist behind high protective barriers. The industries created by these trade policies often followed monopolistic or oligopolistic pricing policies, operated with substantial excess capacity, were unable to compete in export markets, and depended on costly imported inputs. Policymakers also became aware of the costs of negative real interest rates resulting from government regulation of bank interest rates below the rate of inflation. In addition to higher interest rates, financial reforms called for the creation of a wider variety of financial assets to make saving more attractive and to channel a larger amount of funds into longer term investments.

A second important influence on the new orthodoxy was the evolution of monetarism itself. As Diaz Alejandro notes (p. 123), where the monetarism of the 1950's and 1960's saw the money supply as the main determinant of the price level and used the exchange rate to move toward the balance of payments target, the new orthodoxy, uses the growth of domestic credit to meet the balance of payments target and considers the pace of devaluation as the most important determinant of the rate of domestic inflation.

Finally, the 1970s witnessed the ascendency of authoritarian regimes that saw their role to some extent as the reestablishment of economic discipline after a populist period of ungoverned expansion had raised the threat of chaos.[13] Thus, the new orthodoxy of the 1970's produced stabilization programs that integrated the domestic economy with international economic realities and radically restructured the domestic economy along free market principles. While nothing in monetarism calls for an authoritarian state to back it up, since many of the policies pursued exacted a heavy price from the popular classes, the ability to persist in such policies was clearly greater under an authoritarian regime.[14]

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[10] Some of the literature on this link is cited in Sheahan, p. 267.

[11] The differences between the orthodox programs of the 1970's and earlier programs are summarized in Foxley and Diaz Alejandro.

[12] Much of the literature on trade restrictions is cited in Bhagwati and Srinivasan and on financial repression in Galbis.

## THE NEW STRUCTURALIST CRITIQUE

As in the earlier round of this debate, the position of the structuralists is less a coherent set of alternative policy measures than a critique which claims that the monetarists, by ignoring the economic structures of individual countries, fail to see that these features often reverse the expected outcome of orthodox policies. What is new in recent years is the more detailed and complex analysis of this critique. From intuitive hypotheses, structuralists now offer more complete economic models.

In the 1960's, structuralism was largely a set of supply characteristics, such as inelastic food supply and a high degree of monopoly power in small domestic markets, presumed to create a strong bias toward inflation. Orthodox policies to check inflation were seen as leading to intolerably low growth. Contemporary structuralism casts a much wider net. According to Lance Taylor, the structure of a particular economy comes from the institutions and behavior of its citizens which ". . . make some patterns of resource allocation and evolution substantially more likely than others" (1983, p. 3). The structural economist theorizes on the basis of these differing institutions and behavioral responses. The new structuralist theories of inflation, without refuting the old, see developing societies comprising different classes and sectors, with different sources of income and patterns of savings and consumption. The impact of standard macroeconomic policies varies within the structural constraints of these sectors and often reverses the expected outcome.

The remaining paragraphs of this section describe how the workings and expected outcomes of standard orthodox policies become altered in lesser developed countries, beginning with monetary contraction, followed by devaluation, then pricing policies, financial reform, and openness to world competition and capital flows.

In the orthodox approach, demand restraint is accomplished by limiting credit growth, including specific limits on government borrowing and government expenditures. The package of orthodox stabilization measures often results in a quick drop in output growth and, after an initial acceleration, a slow decline in the rate of inflation.[15] The orthodox explanation of the initial acceleration of inflation is due to a combination of lagged effects of past rapid money supply growth and current effects of corrective increases in relative prices of imported goods (i.e. devaluation) and goods whose prices the government had controlled to fight inflation (i.e. public services and housing). The slower or negative growth should be accepted as a worthwhile price to pay for greater future growth that will be possible when inflation is cured and the inefficiency resulting from government controls has been reduced.

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[13] The Argentinian case is discussed in Canitrot.

[14] Sheahan spells out how orthodox policies are perceived, in some cases falsely, to hurt the economically less powerful and suggests that in their application strict efficiency criteria might be relaxed somewhat in order to gain the viability that comes with popular acceptance.

[15] Both Diaz Alejandro and Foxley note the pattern of slow, unsatisfactory decline in rates of inflation.

The new structuralists tell a different story. While acknowledging that devaluation and increases in government controlled prices will initially push up the rate of inflation, they contend that monetary contraction itself is inflationary because firms feel pressured to raise prices while cutting production, There are two lines of reasoning behind this conclusion. One, expressed by Micharel Bruno and Lance Taylor (1983, Ch. 5), pinpoints the impact of monetary contraction on the cost of working capital to the firm. The other, spelled out by Foxley, stresses the uncertainty about future inflation faced by producers when price controls are ended.

## BRUNO AND TAYLOR

Bruno and Taylor argue that in semi-industrialized countries, the cost of borrowed working capital must be considered in the pricing and production decisions of the firm along with that of other variable inputs, such as labor and imports. These firms are highly vulnerable to variations in the interest cost of working capital. They need to maintain larger inventories because of unreliable transport systems. More importantly, structuralists argue that the market for capital in these countries is compartmentalized into different segments. Because bank credit at controlled low interest rates is typically rationed to firms at less than their full need for working capital, they are forced to find additional funds in the domestic non-bank informal sector or "curb" market. Since lending in this sector is done by a large number of relatively small operators at rates that are high and variable across lenders, the cost of borrowing in this market rises with the amount borrowed. A monetary contraction will both restrict the growth of rationed bank credit and, by reducing the total amount of credit available, will force up rates in the curb market. Firms will be forced to obtain more of their working capital in this market and thus will see their costs jump sharply. The normal business response, Taylor notes (1983, p. 193), will be to cut production while trying to pass on these higher costs in the form of higher prices. As contractionary policies lower demand, it is possible that supply will fall even more rapidly, creating an increase rather than a decrease in demand pressures and stimulating inflation. The key determinant of whether this perverse effect takes place is the relative importance of short-run borrowing costs to other short-run costs. Where short-run borrowing costs are proportionally large, short-run supply fluctuations will be more closely linked to the growth of the money supply.

## FOXLEY

Foxley reaches the same perverse inflationary result from short-run monetary contraction by focusing on the differential treatment of wages and prices in stabilization plans such as those in Chile (since 1974) and Argentina (1976–78). Wage levels were fixed, but prices were freed after a period of controls. Foxley reasons that, with the ending of controls, producers expected large price increases but were unable to gauge how high these price increases would be. Fearful of losses if they set their prices too low, they initially raised their prices by even more than the rate of inflation they expected, causing actual inflation to overshoot the rate that might otherwise have been expected. Thus, after the lifting of controls in 1976, Argentina inflation raced ahead of levels that would have been expected on the basis of recent and current money supply growth and rates of devaluation.[16] Rising inflation coupled with slower money growth picked up further momentum as expectations of inflation and actual prices were adjusted to take into account the inflation observed since prices were decontrolled.

With wages fixed, the unexpectedly high rate of inflation reduced the buying power of workers' incomes and of assets held in the form of money. Purchasing power fell sharply, and producers, faced with a growing stock of unsold goods, were forced to reduce production and employment. As production fell, inflation began to weaken but, Foxley argues, at a pace that was tortuously slow because many industries had only a few firms which found it advantageous not to engage in price competition with each other.

For Taylor, the higher interest cost of working capital causes supply to fall more rapidly than demand, producing demand pressure, higher prices, and falling output. According to Foxley, the acceleration of inflation is due to the enormous uncertainty that accompanies the end of price controls causing producers to more than compensate for expected inflation. The subsequent recession is induced strictly on the demand side.

The new structural approach also see devaluation producing effects opposite to those predicted in orthodox programs. Devaluation has a negative rather than a positive effect on output growth, but the structuralists differ among themselves on which of the negative output effects of devaluation dominate.

## THE ROLE OF DEVALUATION

Devaluation is included in orthodox stabilization programs largely because of the belief that, by raising the relative domestic currency prices of exports and imports, devaluation will stimulate the production of traded goods, boost the growth of total output, and help narrow the trade deficit.[17] The structuralists counter that the increase in production of traded goods will be minimal, while the overall short-run impact of devaluation on growth is likely to be negative. In their view, the improvement in the balance of payments comes largely through the impact of slower growth on imports. If a country's exports are dominated by primary agricultural products (as is the case for Argentina, Colombia, and Uruguay)[18] or by another product whose supply is relatively fixed in the short-run, devaluation will have little effect on export production. Coffee bushes, for example, only come into production after several years. On the import side also, the structuralists argue that devaluation will have at best a modest impact in spurring domestic output. After decades of pursuing an import-substitution strategy, most industries have already replaced imports or the domestic capacity to produce the product does not yet exist. Devaluation can only stimulate higher production in the relatively small sector of the economy where imports and domestic products genuinely compete with each other.

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[16] For the relevant date, see Foxley, p. 207.

[17] For a description in the balance of payments and income effects of devaluation in orthodox theory, see Kreinin pp. 124–136.

[18] Country data on the share of agriculture in total exports are presented in the 1983 edition of the World Bank's "World Tables," Vol. 1, p. 520.

The structuralists argue that three negative effects will tend to dominate: (1) higher import prices will reduce domestic liquidity and aggregate demand; (2) income will be redistributed from low to high savers; and (3) the firm's cost of working capital will increase. The first effect is quite straightforward. The higher prices for imported goods will be inflationary beyond their weight in domestic consumption, because they make up a large part of inputs used in domestic production and, in some cases their price increases encourage price increases for competing domestic products. These price increases will reduce the real buying power of assets such as money, whose value is denoted in domestic currency, thus shrinking liquidity and reducing aggregate demand.

The negative demand effects from income redistribution are based largely on the assumption that entrepreneurs have a much higher saving propensity than wage earners.[19] Even where devaluation does not quickly produce higher export volume, higher domestic currency prices of exports and imports will tend to transfer income away from workers to exporters and producers of import substitutes who will save more of this income than workers would have had they been able to hold on to it.[20] In a country like Argentina where the main export products, wheat and beef, absorb a large share of the average worker's income, this redistribution effect can represent a substantial drag on buying power in the economy.

Stressing a third negative effect, Bruno argues that devaluation will also tend to reduce output by raising the cost of working capital. A large portion of industrial imputs are imported and can not be easily substituted for by domestic products. Devaluation, therefore, increases firms' input costs and demand for working capital. With credit rationed, these funds will have to be obtained in the "curb" market where the sudden sharp increase in credit demand together with slower money growth may drive interest rates so high that firms choose to reduce production rather than borrow at exorbitant rates.

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[19] The redistributive effect is emphasized in Ahluwalia and Lysy who cite the important earlier studies (p. 154).

[20] Also, because devaluation raises the domestic currency prices of imports and exports, it gives an income gain to exporters while causing a loss to importers. Inasmuch as devaluation is usually undertaken at times when imports are much greater than exports, the total loss to importers will be greater than the gains to exporters, bringing a further reduction in total purchasing power.

## SOME EMPIRICAL STUDIES

Both camps acknowledge that devaluation has both positive and negative effects on output growth. The structuralists argue that, because it will take time for the positive effects to occur, the negative are likely to dominate in the short-run. Thus far, empirical evidence on this question has been sketchy and informal. Richard Cooper noted a strong tendency in developing countries for devaluation to be followed by reduced output growth, while various studies by staff members of the IMF find no such tendency (e.g. Reichman and Stillson, and Donovan, 1981 and 1982). The case for contractionary devaluation has been weakened by the increasing evidence for individual developing countries that exports do respond strongly to price incentives, suggesting that the positive effects are stronger than some structuralists would have us believe. Both Diaz Alejandro (p. 124) and Foxley (p. 218) note the strong responsiveness of non-traditional exports when the exchange rate bias against exports was removed in Uruguay, Chile, and Brazil. Gylfason and Schmid, based on an empirical study of ten industrial and developing countries, argue that contractionary devaluation appears to be something of a theoretical curiosity since for eight of ten countries, the positive effects of devaluation dominated the negative ones and in the other two, devaluation had only a small negative effect on real income. Interestingly, however, for Brazil, the only Latin American country they considered, the effect was negative.

Tests using data for sixteen Latin American countries for the period 1955–1969 show a strong negative impact of devaluation on growth. (Sheehey, 1985). Because devaluation is often undertaken in concert with a reduction in the money supply, which itself will reduce output growth, the test procedure controlled for the impact of monetary policy. It also took into account the impact of variations in demand from industrial countries. On average, a 15 percent devaluation decreased growth in the current year by 2 percent.[21] As might be expected, the impact of devaluation varied with the degree of industrialization. For the more industrialized countries, production is more dependent on imports, and devaluation has a greater negative impact on output growth. While it would be a mistake to claim too much for this one set of tests, they are the only tests of the contractionary devaluation hypothesis for Latin America and they give it strong support.

Structuralists also argue that attempts to reform the economy along free market lines can worsen the distribution of income, create high levels of unemployment, and slow output. In addition to devaluation, efforts along these lines involve relative price changes across economic sectors (industry versus agriculture or traded versus non-traded goods) and income groups (wage earners versus entrepreneurs), as well as financial reform.

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[21] The devaluation variable was the percentage change in the domestic exchange rate (number of domestic currency units per dollar) minus the percentage increase in the domestic consumer price index; thus it measures changes in the exchange rate relative to domestic inflation.

## RELATIVE PRICES

As Taylor explains, relative price changes can easily have negative output effects in countries where price behavior and output responses vary considerably across sectors. In agriculture, for example, attempts to raise production by increasing relative agricultural prices through devaluation will translate into higher farm income received for the same amount produced because agricultural supply is not price responsive in the short-run. At the same time, the devaluation and higher agricultural prices will cut the real income of the non-agricultural sector. The overall impact on demand for non-agricultural production hinges on whether this demand is dominated by non-rural income. If it is, then the impact of the relative price change is to lower aggregate demand. This negative effect would seem most likely in the more advanced Latin American countries in which the service and manufacturing sectors, taken together, are especially large relative to agriculture.

A similar line of argument applies to reductions in food subsidies. Lower subsidies will mean higher prices for consumers, which in turn lowers demand and pressures domestic producers to cut production. The overall effect wil be lower incomes for producers and consumers which could easily translate into reduced demand for non-agricultural goods, dragging total output down. Reduced subsidies, the structuralists are quick to point out, will also tend to hurt equity since it is presumably the poor who benefit most from controlled food prices. Against the theoretical justifications for subsidies, it can also be argued that income distribution in Latin America is already for more unequal than in any other region of the world. In Peru and Brazil, for example, the share of total household income received by the poorest 20 percent of all households was 2 percent in 1972.[22] Where income distribution is already so unequal, measures that suddenly and significantly lower the income of the very poor would seem to threaten large numbers of people with catastrophe.

## INTEREST RATES

Recent orthodox programs, such as those in Chile and Argentina, have also, in varying degrees, sought to achieve domestic financial reform while opening up to international trade and capital flows. New domestic financial policies consisted of a partial freeing of bank interest rates that traditionally had been held below the market rate, together with the development of financial instruments with longer maturities. Standard economic theory suggests that higher interest rates will induce higher savings rates and, as long as interest rates do not rise above the level at which the supply of savings equals the demand for investment, will lead to higher investment. Standard theory, however, does not take into account the segmented capital markets characteristic of developing countries, the important role of working capital in the firm's production function, and the impact of political instability on investment behavior. Granting that higher interest rates on bank deposits will draw in more savings, the question Taylor asks (1983, p. 197), is from where? If it is from the sale of unproductive inflation hedges like gold, then there is a genuine increase in funds available for investment. But, if bank rates are sufficiently high, funds could also be drawn from the unregulated market. These funds would now be subject to reserve requirements, and there would, therefore, be a contraction in total liquidity.

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[22] These figures are taken from the 1984 edition of the World Bank's "*World Development Report,*" pp. 272–273.

In practice, Foxley contends, the freeing of interest rates in Chile and Argentina at a time of credit contraction meant much higher real interest rates for a sustained period of time. In Chile, real interest rates were over 40 percent for upwards of two years. For firms this meant enormously high borrowing costs for working capital and consequently higher prices and lower production. Investors, mindful of the stop-start nature of past stablilization efforts and of widespread excess capacity, were slow to commit themselves to longer-term financial investment projects, particularly when rates of return on short-term financial investment remained higher than any return they could expect from building a new plant. Foxley claims that the continuing high domestic interests rates in Chile also resulted in consolidation of real assets in the hands of a few large firms. Firms could only achieve the high rates of return that would justify borrowing at home by greatly undervaluing their plant and equipment. Certain large firms, however, were able to obtain lower cost funds on international capital markets and used them to buy undervalued assets of smaller firms in trouble because of domestic recession and high borrowing costs.

## INTEGRATION INTO THE WORLD ECONOMY

The orthodox programs of the 1970s also differed from earlier versions in the seriousness of their attempts to achieve a broad integration of domestic industries and finanical markets with the world economy. Trade and capital flows were liberalized, and the pace of domestic currency devaluation was checked so that more slowly rising import prices could through competitive pressure limit the rate of increase of domestic prices. The rationale for these policies, in addition to the traditional theoretical arguments that free trade will improve resource allocation, lay in a shift away from the simple quantity of money approach toward the law of one price. Policymakers operating under the quantity theory seek to limit inflation by controlling the amount of money in circulation. In an economy open to trade and capital flows, however, the authorities' ability to manipulate the international component of the monetary supply is lost, and their focus shifts to the growth of domestic credit which, if excessive, will cause a balance of payments crisis. Embracing the law of one price, which states that the degree of competition is so intense that it is not possible to maintain different prices for similar goods for any length of time, this approach argues that the rate of domestic inflation will equal the rate of world inflation plus the rate of local currency depreciation. In this framework, the balance of payments goal is targeted by domestic credit growth, inflation is lowered through the discipline imposed on the monetary authorities by freer trade and capital flows and the impact of a slow, preannounced pace of currency devaluation on inflationary expectations, and output growth should be boosted by a more efficient allocation of resources achieved as a result of increased competitive pressure from imports.

Structuralists claim that the actual sequence of events fell short of these expectations. The combination of restraint on domestic credit and the partial freeing of interest rates pushed domestic interest rates up very sharply so that domestic financial assets became highly attractive to domestic and foreign investors, and foreign borrowing was now greatly advantageous for those domestic enterprises that had access to foreign capital markets. All this added up to a considerable inflow of foreign capital and a run-up of foreign exchange reserves. The improvement in the balance of payments induced the authorities to let the rate of depreciation lag. For domestic producers of tradeable goods, this combination of policies, which included import liberalization, was devastating. For producers of import substitutes, lower tariffs brought increased competition. In addition, the role of the exchange rate in maintaining the trade competitiveness of domestic producers was sacrificed in the fight against inflation. However, the rate of inflation continually ran ahead of the crawl of the exchange rate peg and the resulting greater and greater overvaluation of the currency had a strongly depressing effect on domestic output of exports and import substitutes. When holders of domestic assets realized that a large devaluation would soon be necessary, they began to speculate against the local currency, hastening the arrival of a new foreign exchange crisis.

## A CASE STUDY OF THE STRUCTURALIST-ORTHODOX DEBATE: PERU, 1975–78

In the orthodox position, Peru in the mid-1970's was a classic case of instability arising from excess demand which had been allowed to persist for so long that there was no alternative to a harsh dose of the standard policies. That the crisis resulted in large part from poor government policies and unfavorable external events, such as lower copper prices and disappearing anchovies, was not in dispute. The debate hinged on three other issues, namely; (1) whether or not the economy was experiencing excess demand; (2) the likely effects of orthodox policies; and (3) the ready availability of alternative policies.

William Cline, in a well-received statement of the orthodox position, claims that government policy was largely responsible for the crisis through its neglect of exports and its ambitious investment programs, both of which were financed by resorting to large scale foreign borrowing. Evidence of excess demand, he claims, is available in the rapid increase of government expenditures in the face of stagnant revenues. Arguing that orthodox programs do work as predicted, Cline challenges the structuralists' assumptions that in the short run, imports and exports are unresponsive to changes in relative prices and that the burden of orthodox policies falls most heavily on the poor. In his empirical estimates for the period 1955–1978, exports as well as imports showed a significant degree of responsiveness to devaluation and, in fact, over the course of the stabilization program both showed dramatic changes in response to the combined impact of devaluation and demand contraction. Cline also rejects the popular conception that the stabilization program, by sharply reducing real wages and phasing out subsidies for food and gasoline, made the distribution of income even more unequal. The burden of declining real wages fell most heavily on workers in the urban formal sector of the economy where incomes are already relatively high. Even within this sector, wages of higher paid workers (white collar) dropped by a greater percentage than those of lower paid workers (blue collar). Furthermore, since subsidies on food and fuel are more beneficial to families higher on the income scale, their elimination would serve to make income more rather than less equal. As to the structuralist alternatives, Cline finds they lack specificity to deal with the immediate crisis and tend to count on new financial transfusions which are not available.

Schydlowsky gives a structuralist interpretation of the Peruvian crisis, expressing a view directly opposite Cline's on each of the three points. The existence of substantial excess capacity in industry and services, he argues, refutes the contention that the economy was characterized by excess demand. Between 1971 and 1977, Peru had virtually doubled its installed capacity while industrial output increased by only 40 percent. When the possibility of additional work shifts is taken into account, excess industrial capacity was even greater. Output in the labor intensive service industries should also be easily expandable, given the considerable availability of labor. Further, while there was admittedly the need for some short-run demand management, excess capacity was sufficient to sustain enough of an increase in the output of exports and other goods in the medium term so as to close the balance of payments gap and to generate enough new tax revenue to eliminate the fiscal deficit.

If excess demand was not a serious problem, how does Schydlowsky explain the fiscal and balance of payments deficits? He contends that Peru's strong pursuit of an import substitution strategy had produced a maldistribution of the stock of capital goods by inducing expansion in industries heavily dependent on imported materials and machinery while retarding expansion in the mining sector whose exports bring in foreign exchange. The fiscal deficit was partly due to the unbalanced capital stock, which kept actual output and tax revenues well short of their potential, and partly to the recessionary impact of the initial and unsuccessful orthodox stabilization measures which reduced government revenues from what they would otherwise have been.

As for the effectiveness of devaluation, Schydlowsky dismisses Cline's evidence on the basis of econometric methodology and the dispute is left unresolved.[23] Thorp has argued that *a priori* considerations make it difficult to imagine that either Peru's imports or exports could have been price responsive in the short run. About 50 percent of imports were for the state (a substantial part of which was for the military) and the remainder were inputs and capital goods, most of which could not be substituted for in the short run.

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[23] Schydlowsky argues that Cline's import tests are distorted by the increasing use of import controls over the period under consideration and that his results on the export side do not hold if the data are transformed into percentage changes, as Cline does with his import tests.

On the export side, Thorp avers the problem was perceived as not so much competitiveness as production shortages due to the failure to invest in new capacity. Orthodox policies could be expected to improve the balance of trade largely by the impact of recession in cutting imports. The problem with this, however, was that since the bulk of these imports were destined for only a few industries, a generalized decline in output was a very costly way to reduce imports.

The structuralists were split on whether there was an alternative to the orthodox approach in this instance. Schydlowsky argued that, given the availability of labor and productive capacity, it was absurd to stabilize by means of output contraction. Rather, longer-term policies should be employed to correct the imbalance of investment resources while in the short run export promotion makes use of existing capacity to minimize the necessary contraction of output. Thorp, however, is convinced that the policy resources were lacking for so sophisticated a strategy.

## STRUCTURALIST STABILIZATION POLICY

Despite the structuralists' sweeping criticism of orthodoxy, there is no disagreement that any stabilization program is going to include some combination of the standard policies employed in orthodox programs—there are no real substitutes for them. How then would a structuralist stabilization program differ from an orthodox one? There are two main substantive differences. First, because they perceive standard policies as more recessionary and tending to reinforce each other when used in combination, structuralists opt for a more gradual application of these measures in order to avoid a deep recession. Since orthodox programs have tended to boost inflation, gradualism may also improve short-term inflation performance. However, as Diaz Alejandro notes (p. 316), a more modest short-run balance of payments target is called for since the quick results achieved in orthodox programs come from the impact of recession in lowering imports. Preference for gradualism is reinfored by two further considerations. Since the underlying problems are structural, their solutions will take time to work, and longer-term transformations such as a modernized, market-oriented agricultural sector and a more highly developed financial system should not be lost to the immediate need to stabilize the balance of payments. Secondly, to quote Foxley: ". . . abrupt, partial, and asymmetric adjustments in an economy in a state of disequilibrium are bound to produce more disequilibriums, even if successful in reducing imbalances in one particular market." (p. 224) A sudden freeing of imports, for example, in the face of an overvalued exchange rate worsened the disequilibrium (low demand) in the goods markets in Chile and Argentina.

The second major difference of a structuralist program is its recommendation of a wide range of interventionist policies. Structuralists believe that distortions will not go away overnight and thus tinkering with the market creates the opportunity for gains. Almost universally recommended is export promotion to take advantage of unused manufacturing capacity. The distorting disincentives of the past are to be balanced out for a time by distorting incentives such as a more remunerative exchange rate and special credit arrangements. Where orthodox economists would reverse the effects of the long-standing strategy of import substitution by reducing the high tarriffs that it is based on, structuralists contend that this would only work in a more developed economy characterized by flexible wages and prices and, therefore, capable of quick adjustment to greater import competition. But in the semi-industrialized economies of Latin America, where wages and prices are far from flexible, a sudden reduction of tariffs will merely lead to lowered production and higher unemployment. Instead, what is needed is a strategy which first takes advantage of existing excess capacity in manufacturing by making these exports more profitable through measures such as tax breaks and refunds of duties paid on imported materials, then later stimulates domestic demand and employment from a higher level of export earnings and, finally, with a stronger employment base, proceeds to liberalize imports. Bacha argues that this strategy is supported by the considerable success achieved by export promotion measures across Latin America before the new monetarism found its way south (p. 414).

Other policy recommendations include price guidelines, at the start of a stabilization program, for the products of the largest firms in order to prevent overshooting of prices; public investment programs aimed at bottleneck sectors to counter the negative response of private investors mindful of past stabilization failures; and "infant market" protection for weak domestic financial institutions facing competition from larger, more experienced and better endowed foreign firms.[24]

These two key differences at the same time help identify the range, perhaps quite narrow, within which the structural approach is likely to succeed and focus the orthodox disdain for it. The structural approach should be preferred when: (1) the supply constraints they cite actually exist in any economy and cause policy outcomes to differ in a predictable way from those usually expected; and (2) government policymakers have the leeway to intervene or not and the skill to interfere with markets in a restrained and "appropriate" way. Evidence for key structuralist contentions such as the contractionary effect of devaluation and the inflationary impact of monetary contractions is, however, at best inconclusive while the history of market intervention by government is far from encouraging.

Monetarists, for their part, are legitimately skeptical of this critique. Reading the structuralist literature, one comes away with the impression that structuralism is flexible enough to explain almost any economic event after the fact but much weaker in predictive power. Some of the outcomes that structuralists tend to attribute to behavioral and institutional differences across countries, such as a drop in output, as part of the process of reducing inflation by demand contraction, are readily explained by the standard theory. Gordon (pp. 257-263) makes clear that when price expectations adjust slowly, eliminating excess demand will only stabilize the rate of inflation; for inflation to fall, the economy must experience less than full employment for what may prove to be a substantial period of time. For the most part, the structuralists' critique of monetarists' efforts is detailed and specific while the alternative policy prescriptions are largely generalities and medium term measures that count on more credit and more open markets than the industrial countries have shown themselves willing to extend. The structuralist policy recommendations also presume that where governments have intervened in the past with a poor sense of economic reality, they can suddenly do so in a controlled and sophisticated way.

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[24] While many of the structuralists' policy recommendations are spread out over the literature cited, more concentrated treatments are contained in Taylor (1981, pp. 501-502; see also the comment by Dervis, pp. 503-506) and Diaz Alejandro (pp. 133-138).

Some orthodox critics are less reasonable. Harberger dismisses structuralism as not worthy of serious attention because it lacks the scientific content of monetarism which is built around the widely verified demand for money function. Lacking a counterpart to this central notion, structuralism, he contends, has little to offer. But the very point of structuralism is that behavior and institutions vary across countries in such ways that there is no core set of alternative concepts that replace standard theory but merely different sets of distortions, often peculiar to specific countries, that must be taken into account. The lack of a central scientific core of structuralism is not so much its failing as its way of describing a diverse world.

## CONCLUSION

Despite the breadth and intensity of their conflict, the structuralists and monetarists share a range of common views. Economists of both persuasions agree that domestic policy failures in Latin America are to an important degree responsible for the current instability and that the market distortions, chronic inflations and balance of payments crises experienced by these countries have seriously inhibited their growth. For both groups, the goal of policy is not only price and payments stability but also to free these economies of the distortions of past policies as they affect trade, financial markets and bottlenecked sectors. Neither school denies that the continuing series of policy failures reduces the chance of future success as people come to expect failure (e.g. continued inflation) and behave accordingly nor that stabilization programs must include some combination of the standard policies. Their differences boil down to their appraisal of the extent and importance of structural factors and their preference for the main goal of stabilization policy. Orthodox policies are designed to achieve balance of payments and inflation targets while structuralist policies aim for the best possible reductions in inflation and payments deficits that can be achieved without serious declines in output and employment. For the structuralists, the price of orthodox policies is too high.

Discouragingly, the two schools of thought can observe the same events and analyze the same data, yet adopt strongly contrasting views. An exchange between Cline and Schydlowsky suggests that the differences between the two approaches may in good part be due to judgments made before the events occur and the data are generated. Cline takes it as a given that, while the standard orthodox policies may not be appropriate when an external shock causes inflation and a trade deficit in an economy that has followed sound policies and avoided distortions, they will be appropriate in economies where ". . . conditions have been patently overexpansive and trade distortions have been extreme" (pp. 311-312). For Schydlowsky, it is precisely the economies lacking distortions that will have sufficient flexibility to allow the economy to adjust to the across-the-board macromeasures of orthodox policy. But in

> * * * economies with many distortions, where markets have been segmented and have not been allowed to operate fully and foreign exchange scarcity has become a major problem, across-the-board measures are likely to do more harm than good, and specific anti-distorting measures are needed to counteract the preexisting rigidities and to restore the flexibility that the economy had lost" (p. 332).

More positively, while the most recent round of this debate may have won few converts, it has succeeded to focusing increased attention on the phasing and intensity of stabilization policies. The possibility that the joint application of devaluation and fiscal and monetary restraint may have serious contractionary effects must be taken into account and researched. We need to know whether persistent but gradual policies produce higher growth and less pronounced shifts in income distribution over the medium term. If they do, the structuralists will have a firm empirical base for their major policy prescription.

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# THE PERVERSITY OF ECONOMIC INCENTIVES IN LATIN AMERICA AND THE CARIBBEAN *

By Sidney Weintraub

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## SUMMARY

Latin American and Caribbean countries (LAC) have long distorted their price structures by consumer subsidies, wage and price controls, tariff and exchange rate policies. In misallocating resources, these distortions of relative prices have had an important role in restraining growth, aggravating inflation and in accumulating excessive external debt.

The dire economic troubles that have beset the region since 1980 have compelled governments, either on their own or under pressure from the International Monetary Fund from which they have sought assistance, to reduce these price distortions. This they have done by cutting public sector deficits, adopting more realistic exchange rates, removing government controls over interest rates, increasing prices to agricultural producers and altering the structure of import protection.

These measures, together with monetary and credit restraints, have caused severe hardships to large sectors of LAC society. In many countries, real wages have fallen to their lowest levels and unemployment risen to the highest levels in many years. The LAC governments are, at best, reluctant executors of these policies. In general, they tend to blame the economic plight of their countries on external factors over which they have had little control: the deterioration of the terms of trade since the late 1970's, the OPEC oil price increase of 1979, the recession in the industrialized countries of 1981–83, high interest rates and the drastic reduction in foreign lending since 1981.

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*This article was written in early 1985.

Wherever the blame lies, since 1982 the LAC governments have reduced price distortions to a considerable extent and achieved substantial current account surpluses. In doing so, they have laid the groundwork for structural changes that should increase incentives for production and growth in the future.

The willingness and/or political strength, however, of the LAC governments to continue carrying out painful policies is a major unknown. Their chances of staying the course of reform will be greatly improved, however, if the industrialized countries upon which they are so dependent for trade and finance can maintain good growth performance and reasonable interest rates.

## INTRODUCTION

There has been a recurring pattern in Latin American and Caribbean (LAC) countries of seeking to manage prices. This shows up in interest rates lower than inflation (Table 1); overvalued exchange rates (Table 2); internal terms of trade that favor consumers in urban areas at the expense of producers of agricultural goods; the provision of goods and services by state-owned enterprises at less than their cost (or, for gasoline, at less than its scarcity value); relative cheapness of capital goods because of duty-free importation; relative costliness of labor because of minimum wage legislation and limitations on firing workers; and, in the case of foreign trade, a haphazard system of import duties, production and export subsidies, and domestic content legislation. Resource allocation is inevitably affected by this array of prices based largely on government fiat.

The problem of fixing prices of particular goods and services without regard to the impact on the entire structure of prices in an economy is not new, nor is it unique to LAC. What has made the issue particularly relevant recently has been the economic crisis that has afflicted the LAC region since about 1981. This crisis is reflected in key macroeconomic variables: declines or stagnation in gross domestic product (GDP); unsustainable deficits in the current account in the balance of payments of practically all countries of the region; persistent inflation; and burgeoning external debts.

Despite a history of resistance to seeking help from the International Monetary Fund (IMF), country after country in LAC found it necessary during the past few years to enter into a stabilization program involving conditions imposed by the IMF. While these conditions are usually defined as macroeconomic (reduction of public sector deficits, limiting total credit and monetary growth in the economy, and actions to reduce balance-of-payments deficits), the stabilization measures inevitably deal also with relative prices (such as the exchange rate and a reduction of government subsidies on goods and services). Many LAC governments are finding it necessary to reduce real wages, raise real interest rates, alter the structure of import protection and export promotion, and increase producer prices in agriculture.

Many of these actions impose short-term hardships on large segments of society. As a result, the increased recourse to the IMF by LAC countries has been accompanied by a search for alternative techniques for stabilization.

The pages that follow deal with three aspects of this theme. The first section examines the nature and effects of the price fixing that has been so pervasive in LAC. The second section looks at recent actions in major LAC countries to alter relative prices and ask if there are other ways to approach this problem. The final section provides conclusions.

## NATURE OF PRICE FIXING

Countries fix prices for a variety of reasons. The motive may be altruistic, to make goods and services available to persons who otherwise could not afford them. Low transportation costs, subsidies for bread and edible oils, and even negative real interest rates are instituted for this reason. Prices are fixed for political reasons, e.g., to keep the cost of foodstuffs low in urban areas where the bulk of active voters reside. The political basis for price controls can be more calculatingly political, as it was in Chile during the Allende administration as a way to force businesses into bankruptcy. The rationale can be theoretical; this is the basis for import restrictions under the import substituting industrialization (ISI) programs in Latin America. State-owned enterprises have been established to counter monopolies, preserve jobs, and develop resources for which greater amounts of capital were necessary than could be mobilized by the domestic private sector.[1] Once established, these enterprises are assigned social and political as well as economic roles. There is no other way to explain gasoline at the equivalent of 30 U.S. cents a gallon in Ecuador in 1984.

Price fixing can be incoherent, as when exchange rates are kept overvalued to dampen inflation at the same time that public sector deficits are enlarged to provide cheap goods and services. Intended beneficiaries can be damaged, as when government-set low ceilings on interest rates dry up loanable funds and force borrowers to go to usurers; or when businesses devise techniques to avoid hiring persons who cannot later be fired without penalty once vested in their jobs. It is common for one distortion to lead to others designed to correct the initial action. Low producer prices lead to shortfalls in agricultural production requiring imports, sometimes on concessional terms, which further depresses producer prices. High import duties or quotas, particularly when coupled with an overvalued exchange rate, make it necessary for the government to provide subsidies to stimulate exports. Export incentives can become extremely complex. Brazil uses subsidies to promote exports, but then may nullify the effect of the subsidy to avoid U.S. countervailing duties. Not only are some products favored over others, but even the same product has a variety of treatments depending on the export market.

The extent of such price fixing in LAC countries is rooted in a combination of national pressures—which exist in all countries—and theorizing that gave the price fixers a rationale based on social justice and economic development.

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[1] Gene E. Bigler and Alfred H. Saulniers, "The Public Enterprise Sector," in Jack W. Hopkins, ed., "Latin American and Caribbean Contemporary Records" (New York: Holmes and Meier, 1984), pp. 195–207.

Import substitution came naturally to LAC. The collapse of commodity prices and trade during the great depression of the 1930's made imports of manufactured goods impossible due to a lack of foreign exchange. Governments intervened to establish manufacturing enterprises themselves or to finance private ventures, mostly in consumer-goods industries. Chile's CORFO (Corporacion de Famento de la Produccion) was established at this time and served as a model for *fomentos* of other countries. The state felt forced to establish industries since private venture capital was mostly lacking. There were comparable developments in the United States at that time, e.g., the establishment by the federal government of power generation and distribution entities (the Tennessee Valley Authority and the Rural Electrification Administration) and state intervention in the economy (e.g., in agriculture and even in industry under the National Recovery Act). The previously relatively open LAC economies were embarked on a road leading by successive steps toward closure.

There was no lack of theory supporting import substituting industrialization in the 1930's. Alexander Hamilton's "Report on Manufactures" had advocated ISI for the early U.S. republic and the writings of Friedrich List had reasonable international resonance. The theoretical writings that had greatest influence in LAC, however, came out of the Economic Commission for Latin America (ECLA, now ECLAC with the addition of the word Caribbean).[2] The seminal document was "The Economic Development of Latin America and Its Principal Problems," prepared by Raul Prebisch, then the head of ECLA.[3] There were several interconnected theses that dominated the analysis in this study and subsequent outpourings of ECLA: the "center" dominates exports of manufactured goods and the "periphery" participates in world trade by exporting primary products and importing manufactures; there is a secular tendency for the terms of trade to deteriorate for primary products in relation to manufactures; hence, development in Latin America requires the establishment and protection of national industries to overcome this unequal exchange. The domination of this thinking throughout Latin America during the 1950's and 1960's is a well-known story. The ECLA terms "center" and "periphery" are part of the common parlance in LAC (and elsewhere) to this day.

Practices involving government intervention and consequent price fixing had been applied only modestly in the 1930's. Necessity was the mother of practice. Theory relating specifically to Latin America became significant in the 1950's, and this gave a stimulus to subsequent economic policy, including price-fixing activities. While much attention is paid to export-promoting policies in LAC countries today, ISI remains a powerful force. The most recent Mexican industrial development plan argues that ISI is critical in developing intermediate- and capital-goods industries; and that since many of these industries require substantial injections of capital, the state must continue to play a management and price-setting role in industrial development.[4] Brazil's industrial development policy is replete with import restrictions to protect domestic industries and domestic-content requirements to assure that producers obtain their intermediate inputs from these industries. These actions necessarily depart from allowing markets to set prices.

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[2] The acronym LAC overstates somewhat, since the greatest influence of ECLA in its early history was on Spanish- and Portuguese-speaking Latin America.

[3] United Nations Economic Commission for Latin America (Lake Success, N.Y.: Department of Economic Affairs, 1950).

Many price-fixing practices grew out of the LAC inflationary experience. It is history now, but during the 1950's and even into the 1960's there was heated debate between the structuralists, who argued that the peripheral nature of the LAC economies, linked to their reliance on imports of manufactures, and the deteriorating terms of trade, were the main cause of inflation, and the monetarists, who took a more orthodox position that inflation resulted from excessive monetary creation.[5] The structuralist position reinforced the ISI philosphy. It argued that inflation was inevitable until the peripheral structure of the LAC economies was altered. The position was hard to maintain in its extreme form since countries in other regions, particularly Asia, were developing an industrial base without LAC inflationary levels. However, if one believes that the structure of the economy must be altered before inflation can be lowered, the interim alternatives to deal with inflation are to index (try to make the inflation as painless as possible), or to directly fix prices. Both were practiced. It was common in LAC to fix low prices for precisely those items that had heavy weights in consumer price indexes to demonstrate that inflation was being brought under control.

Holding official exchange rates fixed despite inflation higher than in trading partners had a practical purpose—to hold prices down for imported goods—and also a theoretical underpinning. LAC economic literature of the 1950s and well into the 1960's is replete with elasticity pessimism, i.e., that devaluation of the currency will not alter relative returns as between selling in the home or the export market sufficiently to provide a significant stimulus to exports.[6] This pessimism was related to the structural explanation of inflation; that is, it is the structure of LAC economies that impedes exports of manufactures (most primary products were priced in dollars) much more than the price.

This brief historical excursion into the motives for price fixing in LAC would not be complete without citing the strong influence of populism throughout the region. Popularity was sought in country after country by keeping allowable interest rates low. Juan Peron came to power and stayed there by promising higher real wages year after year. Mexican governments took over many enterprises in order to save jobs. There was a recurring cycle in LAC countries of populist-induced inflation stemming from large public sector deficits and accommodating monetary policy, followed by efforts at stabilization that could not be maintained as real wages were forced down, only to be succeeded by another bout with populism. The rational resident of an LAC country came to expect that stabilization programs would fizzle before they had run their course.

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[4] Poder Ejecutivo Federal. "Programa Nacional de Fomento Industrial y Comercio Exterior, 1984–1988" (Mexico, D.F.: Secretaria de Comercio y Fomento Industrial, 1984).

[5] There is a brief discussion of the structuralist-monetarist debate in Albert O. Hirschman, "Journeys Toward Progress: Studies of Economic Policy-Making in Latin America." Originally published by Twentieth Century Fund, 1963 (New York: Norton Library edition, 1973), pp. 212–217. Citations are provided to other readings.

[6] The general inappropriateness of elasticity pessimism is touched on in Tony Killick, Graham Bird, Jennifer Sharpley, and Mary Sutten, "The IMF: Case for a Change in Emphasis," in Richard E. Feinberg and Valeriana Kallab, eds., "Adjustment Crisis in the Third World" (New Brunswick, N.J.: Transaction Books for the Overseas Development Council, 1984), p. 77.

The LAC economic practices had their successes. GDP growth, which is a more significant indicator then prices, averaged in excess of 5.5 percent a year in LAC countries during the 1960's and 1970's.[7] GDP growth rates varied among countries, but they were high in the two most populous countries, Brazil and Mexico, which together have more than half of the LAC population. The region's economic problems emerged in full force only in the 1980's. Per capita GDP declined for three successive years, 1981 through 1983, by 10 percent for the three years together.[8] The movements in LAC terms of trade were ambiguous for most of the period after the ECLA thesis was first promulgated,[9] but the complaint was unambiguously true for LAC countries jointly from 1981–83, and for the three years prior to that as well for the non-oil LAC countries. The total decline for the latter was a stunning 38 percent between 1977 and 1983 which, as ECLA has pointed out, is a decline comparable to that of the great depression.[10] Interest payments on foreign loans and profit remittances from foreign direct investment outstripped capital inflows from new external credits and investment in 1983 and 1984. These developments forced a rethinking of policies, including price policies. What was tolerable during the relatively prosperous years became questionable, even urgent, during the years of economic hardship. It has now become fashionable to talk about "getting prices right." Is it just that, fashion, or is there a deeper basis in economic growth to be concerned about in the price-fixing practices of LAC?

On a simple level, common sense and centuries of economic analysis tell us that prices affect behavior. The issue needs little elaboration. Exports from South America to the United States rose by 34 percent (nominal values, based on U.S. import data) for the first nine months of 1984 compared with 1983.[11] This presumably was caused in part by greater U.S. economic growth in 1984 than in 1983, but also by real devaluations of currencies. There is extensive analytical literature demonstrating that higher producer prices stimulate agriculture production and that catering to urban residents by keeping producer prices low discourages output.[12] Smuggling of gasoline and other petroleum products from Ecuador to Peru is common to take advantage of higher prices in Peru. A study comparing workers per million dollars of output in manufacturing in Mexico and South Korea showed that more than twice as many workers were used in South Korea, where wages and related cost-raising benefits were lower, especially in relation to the cost of capital goods.[13] The existence of black markets, for money, goods, food, and services is a demonstration that relative prices affect behavior. So do post-Christmas sales in retail stores. Illustrations could be given endlessly.

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[7] Inter-American Development Bank (IDB), "Economic and Social Progress in Latin American, Economic Integration, 1984 Report" (Washington, D.C.: 1984), p. 184.

[8] Enrique V. Iglesias, "A Preliminary Overview of the Latin American Economy During 1983," CEPAL Review, No 22 (April 1984), p. 7.

[9] Lloyd G. Reyonds, "The Speed of Economic Growth to the Third World," Journal of Economic Literature, Vol. 21, No. 3 (September 1983), p. 974.

[10] Iglesias, "A Preliminary Overview," p. 7.

[11] Wall Stret Journal, December 27, 1984, p. 32.

[12] Theodore W. Schultz, ed., "Distortions of Agricultural Incentives" (Bloomington, Ind.: Indiana University Press, 1978) contains essays on this theme.

A more complicated question is by how much differences and changes in relative prices affect behavior. The elasticity pessimism that was common in LAC during the 1950's and 1960's was based on the belief that an exchange-rate devaluation would increase the volume of exports of nontraditional products by less than the percentage change in the price of the currency. There was also official concern in many LAC countries that devaluation of the currency would merely provide windfall profits (in local currency) to exporters of primary products. The export pessimists have been proven to be almost universally wrong in LAC. This lesson has been learned. To cite but one example of a country with a history of recurrent overvaluations of the currency, the current administration in Mexico has stated explicitly that maintaining the exchange rate will not be an objective of policy, but rather that the rate will be used as another instrument of economic policy.

How much, and over what time frame, a given change in prices will affect output, sales, exports, imports, or whatever is being measured, is an empirical question. But one can hardly argue that relative prices do not affect behavior.

The most basic question with respect to price fixing is whether the cost in lost economic growth is greater than the immediate benefits sought from the price-fixing action. There is a budgetary cost when a government subsidizes transportation for the benefit of the poor, but this may facilitate movement to and from work and lead to greater output.[14] Keeping the price of bread and beans low may be cost effective in terms of improved health of a significant portion of the population. There are different ways to provide these benefits, such as subsidies or fixing the price to the producer or provider of the good or service. Resolution of cases of this nature must be based on specific circumstances. What is at issue in this paper is not isolated subsidies or price-fixing decrees, but rather the extensive use of price-fixing affecting large segments of the economy.

The World Bank, in its "World Development Report 1983," reported on a study it carried out based on regression analysis seeking to related GDP growth with the degree of price distortions (in foreign-exchange pricing, factor pricing, and product pricing) in 31 developing countries during the 1970's.[15] The Bank concluded from its regression equation that these distortions explain about one third of the variation in growth performance. The annual average GDP growth for the 31 countries in the Bank sample was 5 percent. For those countries with low distortions, the growth rate was two percentage points higher than the average (7 percent) and for those with high distortions, GDP growth averaged two percentage points lower than the average (3 percent). Some countries did better than the regression estimate (Brazil is one such country) and some did worse (Jamaica is an example). The actual results generally were a reasonably good fit of what was estimated from the regression equation.

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[13] Susumu Watanabe. "Constraints on Labour-Intensive Export Industries in Mexico," International Labor Review, vol. 109 (January 1974), pp. 23-45.

[14] Most urban transportation systems in the United States are subsidized for this reason.

[15] New York: Oxford University Press, for the World Bank, 1983, pp. 59-63.

The same World Bank report refers to individual country studies which point in the same direction of lower overall growth because of high price distortions, and of improvement in growth performance after these distortions were reduced.

The LAC price-fixing practice represents an ambivalence between reliance on the market in these essentially market-dominated economies, and distrust of the market stemming from the sentiment that led to the use of the word "periphery" to describe the region. Some mixture of regulation, government involvement, and price fixing, on one hand, and reliance on the market on the other, is evident in all market-dominated countries. This is the case even in centrally-planned economies, as the recent market-oriented changes in China vividly demonstrate. The bias in most LAC countries has been toward extensive price fixing since World War II. The current economic crisis has forced a change in this bias because of circumstances and the pressure from the IMF under stabilization programs.

## RECENT CHANGES

The debate about the importance of "getting prices right" is far from over. Two major international economic institutions, the IMF and the World Bank, have weighed in heavily on the need to minimize price distortions in the interest of economic growth. Criticism of this point of view takes many forms. One widely-cited study, after accepting the need to alter relative prices, argues that the time needed for adjustment must be longer, and must involve substantially more financing, than in a typical IMF program.[16] One distinguished Latin American economist, while accepting the need to compress imports and build up current account surpluses to service external debt, argues specifically against doing this by contracting internal demand, but instead recommends restricting imports through taxes, tariffs, and discriminating exchange controls. He states that this involves a change in relative prices but with less damage to employment and consumption by the "popular" sectors.[17] In a critique of the World Bank's price distortion study, one U.S. economist noted that the Bank's own data show little difference in overall price distortion between countries with inward and outward looking economies, and that this applies with particular vigor to the differences in distortion in the two key variables, the exchange rate and the real interest rate.[18] Responsible critics, in other words, do not argue that relative prices do not matter, but rather that they matter less than the IMF and World Bank believe; and, in any event, there are many paths to altering relative prices, including temporary, additional price distortions on foreign trade and consumer necessities.

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[16] Tony Killick and Mary Sutton, "Disequilibria, Financing, and Adjustment in Developing Countries," in Tony Killick, ed., "Adjustment and Financing in the Developing World: The Role of the International Monetary Fund" (Washington, D.C.: International Monetary Fund and Overseas Development Institute, London, 1982), pp. 48–72.

[17] Osvaldo Sunkel, "Past, Present and Future of the International Economic Crisis," CEPAL Review No. 22 (April 1984), pp. 81–105.

[18] Colin I. Bradford, Jr., "The NICs: Confronting U.S. Autonomy," in Feinberg and Kallab, eds., "Adjustment Crisis in the Third World," pp. 119–138.

One reason given for the resistance to stringent stabilization programs, including significant changes in relative prices, is that the disequilibria in developing countries are less of their own making than of external circumstances beyond their control.[19] At the Latin American Economic Conference called to deal with the economic crisis, held in Quinto, Ecuador from January 9-13, 1984, the two documents which represented the consensus of the heads of state or government, or their personal representatives, focused almost exclusively on the external factors that brought on the crisis. The Declaration of Quito does state that the "crisis originated in internal and external factors" but then goes on to state that "success in surmounting it (the crisis) is largely dependent on the latter." The Plan of Action accompanying the Declaration of Quito contains the following sentence near the beginning of the document: "The responsibility of the Latin American and Caribbean countries has already been assumed via drastic economic adjustments and enormous efforts to honor their international commitments, despite the high social, political and economic cost thereby implied." [20] This is undoubtedly true. However, the exclusive focus thereafter on external actions, including greater regional trade cooperation, leaves the impression that the reference to internal factors is essentially lip service.

The internal hardships brought on in LAC countries by the economic crisis have been severe. Stabilization programs have aggravated these hardships, at least temporarily. The Executive Secretary of ECLA has noted that in many LAC countries, employment and real wages have fallen to the lowest levels since the great depression. [21] The high social cost of stabilization is not arguable. What is arguable is whether stabilization programs must be as drastic as they have been in recent years and whether the causes of the crisis were more external than internal. A country must take action to adjust to a crisis, whether internally or externally engendered, but the establishment of causation can provide guidance for future policy.

A study by Enders and Mattione asks three questions.[22] Were external shocks largely responsible for the crisis? They answer no. Their argument, briefly, is that LAC countries borrowed far more than needed to cover external shocks and used the extra funds indirectly to increase the real exchange rate. These extra borrowings showed up in capital flight. Few countries took action to control burgeoning public sector deficits. Even if the Enders-Mattione answer is accepted as a general conclusion, external factors clearly had a role in aggravating the crisis. Cline has calculated that the balance of payments of LAC countries was burdened by about $400 billion between 1974 and 1982 by costs stemming from the abnormally high U.S. inflation, high U.S. interest rates, export volume loss from the 1981-1982 world recession, and deterioration in the terms of trade in 1981-82.[23]

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[19] Sidney Dell, "On Being Grandmotherly: The Evolution of IMF Conditionally" (Princeton, N.J.: Princeton University International Finance Section Essay in International Finance 144, 1981).

[20] The documents and the citations are from CEPAL Review, No. 22 (April 1984), pp. 39-51.

[21] Iglesias, "A Preliminary Overview," p. 33.

[22] Thomas O. Enders and Richard P. Mattione, "Latin America: The Crisis of Debt and Growth" (Washington, D.C.: Brookings Institution Discussion Paper No. 9, December 1983).

Their second question asks how long it will take to restore growth and improve debt-servicing capacity, and their answer is, even with good luck, probably most of the decade. Their third question deals with the strategy best designed to improve LAC economic performance, and their answer is export-led recovery based on further small real devaluations.

Whatever the philosophic arguments, relative prices in Latin America are changing. One driving force has been the need to improve current account positions in the balance of payments. The LAC current account deficit burgeoned in the early 1980s, from about $19 billion in 1979 to almost $41 billion in 1982. The decline after that was dramatic, to $9 billion in 1983 and an estimated $3 billion in 1984.[24] The improvement in the merchandise trade balance in 1983 for the LAC region as a whole was due solely to a decline in imports (by 28 percent, from $82 to $59 billion).[25] By contrast, the increase in the surplus in trade in goods in 1984 was due solely to a 9 percent increase in exports.[26] The major trading countries, Brazil, Mexico, and Venezuela (together they accounted for 65 percent of LAC exports of goods in 1983) are all heavily in debt to external creditors and had no choice but to seek current account surpluses. Each had an effective real devaluation of its currency in 1983 and each did not allow excessive real appreciation of the currency in 1984. Economists in these countries now talk of the desirability for some undervaluation when before the objective was to prevent excessive overvaluation. The real exchange rate was depreciated in many other countries as well in 1983 and 1984. Elasticity pessimism may not be fully dead, but it is certainly quiescent.

A similar development was taking place in interest rates. The drastic turnaround in the current account after 1982 meant that the LAC region suffered a large decline in the inflow of external savings. Indeed, the LAC outflow for interest payments and profit remittances exceeded capital inflow by $31 billion in 1983 and an estimated $26.7 billion in 1984.[27] As a consequence, the ratio of investment to GNP declined, from almost 26 percent in 1981 to less than 20 percent in 1983.[28] Real interest rates were increased in country after country in an effort to increase domestic savings.

A comparable story can be repeated for other prices. Real wages were lowered in many countries—indeed, the extent to which this would occur became a major sticking point between Brazil and the IMF in 1984—as part of demand-constricting, inflation-fighting policies. These reductions, probably above all other measures, are what the leaders of the LAC countries had in mind when they referred in the Declaration of Quito to the "high social, political and economic cost" of stabilization programs. The stabilization programs in many countries, including the major countries, involved severe reductions in public sector deficits and accomplishing these required lowering or eliminating subsidies on many basic products, such as foodstuffs and gasoline. These cost-increasing measures for consumers coincided with declines in total income, aggravating the social hardships of the poorest groups in many countries. The ideal time to raise prices for basic necessities, if they must be raised, is when an economy is on the upswing. In practice, these prices tend to be raised under the pressure of necessity, when an economy is declining. This was the case in LAC during 1982-84.

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[23] William R. Cline, "International Debt" (Cambridge, Mass.: MIT Press for the Institute for International Economics, 1984), p. 13.

[24] CEPAL News, Vol. iv, No. 5 (December 1984), p. 1.

[25] IDB, "Economic and Social Progress, 1984 Report," p. 445.

[26] CEPAL News, December 1984, p. 1.

[27] Ibid., p. 2.

[28] IDB, "Economic and Social Progress, 1984 Report," p. 189.

What seems to have taken place during this time of economic crisis is that distortions in the various types of prices—for foreign exchange, factors, and products—have been reduced. Many of the reductions have been both drastic and precipitate. It is not clear whether the reductions in price distortions have been made out of conviction by national leaders or because of the pressure of circumstances (and of the IMF in countries in which there are standbys or extended Fund programs). This may make a difference in the future.

It is valid to raise the question whether changes in relative prices, and IMF stabilization programs generally, have been too precipitate. This leads to a corollary question: What were the options available to LAC countries?

One must keep in mind the setting. There are obviously differences among countries, but the circumstances for the LAC region as a whole were particularly dire after 1981—more so than at any time since the great depression. Debt payments could not be met, certainly not on the principal. Capital inflows were drying up, and if one considers interest payments on external debt as capital outflow, the region was becoming a capital exporter. Current account deficits of the magnitudes previously reached had become a financial impossibility; a country cannot spend foreign exchange it does not have or go into debt when there are no willing sources of credit on terms and conditions the countries are prepared to accept. Increased official foreign aid would have been welcome, but the amounts needed were beyond what would be made available. This was especially true for middle-income countries of the type that predominate in LAC, particularly since a large portion of the capital that flowed in during the previous few years merely fled out again. It was clear that there would be no increase in official foreign aid sufficient to compensate for the decline in commercial bank lending; and even the external capital that was forthcoming—commercial or official—was bound to be conditioned on substantive changes in economic policies.

Under these circumstances, the LAC countries did what they could. They drastically curtailed imports, using both quantitative restrictions and changes in relative prices through real devaluations. It was possible to limit imports without directly raising their prices by using quantitative controls, but it was not possible to significantly increase exports without altering relative prices—unless governments were prepared to provide massive subsidies at the very time that other subsidies were being curtailed to reduce public sector deficits. Consequently, exchange rates were depreciated.

As the inflow of foreign savings reversed and instead LAC found itself providing its savings to the developed countries—to the region's creditors—negative real interest rates that discouraged domestic savings became increasingly untenable. If domestic inflation were to be brought under some control, there was little alternative to holding down real wages, or even reducing them. Much the same can be said for the need to reduce public sector deficits and to limit money supply and credit increases.

In order words, the situation faced by LAC countries gave little scope for temporizing in the hope that there would be a quantum leap in external resources. National leaders could theorize about internal or external causes of the crisis, but there had to be contemporaneous action.

Without getting into the debate as to whether stabilization programs are generally best carried out rapidly or gradually, many of the LAC countries had little leeway but to act quickly—at once, if not sooner, in the case of Mexico at the end of 1982—with respect to many of the prices in their economies. If exports were to be promoted without subsidies, the exchange rate had to be depreciated. If current account positions were to be improved, imports had to be restricted. If domestic savings were to be encouraged, real interest rates had to be increased. If public sector deficits were to be reduced, many programs had to be curtailed. If inflation were to be addressed, real wages had to be controlled.

The choices open to governments were extremely constrained, namely, by how much to devalue the currency, or to reduce public sector deficits, or to hold down real wages, or to increase real interest rates. These are political questions, answerable only in the context of particular countries. What was unarguable at the height of the economic crisis was that countries had to deal with distorted relative prices. What countries tried to do, at least those that faced the economic crisis squarely, was to deal simultaneously with the short-term balance-of-payments problem and to lay the basis for longer-term structural adjustment via changes in relative prices and a shift of resources from the public to the private sector by lowered ratios of public sector deficits to GDP, and to export-led recoveries. The staying power of countries for these longer-term structural adjustments continues to be a major current unknown.

## CONCLUSIONS

Four paramount conclusions emerge from the discussion and analysis in this essay.

1. The evidence seems irrefutable that LAC countries have sacrificed efficiency and growth from distorted pricing. One can argue about the extent of economic growth foregone, but not about the direction. One can understand the reasons why LAC governments sought to fix prices, stemming from their historical experiences, their situation in the world economy, and their individual domestic political situations, but this does not alter the cost of distorted in-

centives—less than optimal efficiency in the allocation of resources and lower growth of GDP than could otherwise have been achieved.

2. When the severe economic crisis hit the region in 1981 and thereafter, LAC countries had to manage reality. Countries did not have the choice not to change price policies, but only the degree to which relative prices would be altered. The need to modify past policies affected prices across the board—of foreign exchange, factors (wages and interest rates), and products. Almost without exception, relative prices have changed in LAC countries since the onset of the economic crisis, more sharply in some countries than others, with more or less hand wringing, and with different political repercussions—but change they have under the pressure of circumstances.

3. The LAC countries' economic, and hence political, futures are not solely in their own hands. As countries opt for more export-led growth as the escape from debt-service burdens, their success depends on rates of economic growth and of interest costs in the developed countries. To the extent that LAC countries trade more among themselves, this dependence on developed country growth can be reduced, but it cannot be eliminated. Intra-regional exports are between 15 and 20 percent of the total, and of this, only some 20 percent is in manufactures,[29] for which export growtrh is apt to be most dynamic.

Having said this, LAC countries will have to make the best of a good or bad situation that may exist outside the region.[30] Countries must adjust to economic conditions whether the cause is internal or external. Justice should require that internal institutions and the developed countries will temper their actions and demands vis-a-vis LAC and other developing countries depending on the causes of an economic crisis, but it would be imprudent to expect too much from this. The recent LAC economic crisis coincided with an economic crisis in the developed countries and the latter quite naturally paid more attention to their own deprivations than to those in LAC countries—even though the latter were more severe. LAC countries cannot expect much external assistance in the future if their economic problems are caused by distorted relative prices. They can expect more sympathy but probably little more tangible assistance even if their problems are caused by external circumstances beyond their control.

4. The most important unknown is whether the recent changes leading to less distortion in relative prices than in the past will be durable after LAC countries recover from the recent hard economic times. The answer will be important at the time of the next economic crisis.

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[29] Ibid, p. 91.

[30] A quotation from the head of the Bank of Mexico is relevant to this assertion: ". . . given the structural changes currently evident in Mexico, the need becomes clear to avoid adopting policies which, while having the intended effect of disconnecting our economy from the oscillations of international economic cycles, which inevitably will affect us, serve rather to postpone and complicate its normal adjustment and thus become an additional source of instability." Miguel Mancera, "Thoughts on Certain Structural Changes in the Mexican Economy that Occurred in Recent Decades," Banco National de Mexico (Banamex), "Review of the Economic Situation of Mexico," vol. 60, No. 706 (September 1984), p. 333.

TABLE 1.—SELECTED LAC COUNTRIES: INTEREST RATES AND INFLATION

| | June 1980 [1] | June 1979 [1] | June 1978 [1] |
|---|---|---|---|
| Argentina | 6.9 | −3.8 | −17.1 |
| Brazil | −5.2 | −3.6 | −5.3 |
| Chile | 14.0 | 13.1 | 18.2 |
| Colombia | 5.9 | −4.5 | 0 |
| Ecuador | −5.1 | .4 | .3 |
| Jamaica | 2.2 | −15.9 | −15.1 |
| Mexico | −9.5 | −8.7 | −2.4 |
| Peru | −25.3 | −13.8 | −27.9 |
| Uruguay | 12.2 | −13.8 | −10.1 |
| Venezuela | −4.8 | −8.8 | −2.2 |

[1] Computed $100[(1+i)/(1+p)-1]$, where i is the nominal interest rate, generally on 12-month time deposits, p the change in the consumer price index over the previous 12 months, both expressed in decimal form.

Source: "Interest Rate Policies in Developing Countries," International Monetary Fund Occasional Paper 22, October 1983, p. 4.

TABLE 2.—*Evolution of the real dollar exchange rate in LAC countries*

| *Period* | *Real Exchange Rate* |
|---|---|
| 1970 | 100.00 |
| 1971-73 | 97.50 |
| 1974-75 | 87.39 |
| 1976-79 | 87.15 |
| 1980 | 76.20 |

**Note**: The consumer price indexes of the LAC countries and the U.S. GDP deflator were used as deflators.

Source: "Economic and Social Progress in Latin America, 1982 Report" (Washington, D.C.: Inter-American Development Bank), p. 44.

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The annual World Bank publication,"World Development Report," provides tables and analyses of issues of economic development. The "1983 Report" (New York: Oxford University Press, for the World Bank) has a thorough discussion of price distortions in developing countries generally. The comparable publication for Latin America and the Caribbean is the annual report of the Inter-American Development Bank, "Economic and Social Progress in Latin America."

There has been a veritable explosion of literature analyzing the policies of the International Monetary Fund since the economic turndown in much of the world in the early 1980s led to greater use by developing countries of the facilities of the IMF. The debt crisis, which was centered in Latin America, was another stimulus to analysis. Three publications dealing with IMF policies are Tony Killick, ed., "Adjustment and Financing in the Developing World" (Washington, D.C.: International Monetary Fund and Overseas Development Institute, London, 1982); John Williamson, ed., "IMF Conditionality" (Cambridge, Mass.: MIT Press for the Institute for International Economics, 1983); and William R. Cline and Sidney Weintraub, eds., "Economic Stabilization in Developing Countries" (Washington, D.C.: Brookings Institution, 1981).

William R. Cline, "International Debt and the Stability of the World Economy" (Washington, D.C.: Institute for International Economics, 1983) is a relatively optimistic analysis of the debt problem; Albert Fishlow, "The Debt Crisis: Round Two Ahead?", in Richard E. Feinberg and Valeriana Kallab, eds., "Adjustment Crisis in the Third World" (New Brunswick, N.J.: Transaction Books, for the Overseas Development Council, 1984), pp. 31-58, is premised on the belief that current optimism is premature.

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# OVERCOMING ARGENTINA'S STOP AND GO ECONOMIC CYCLES

By Marcelo Diamand*

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## SUMMARY

The basic cause of Argentina's slow and erratic economic growth is the pendulum swing between populist policies on the one hand and orthodox economic strategies on the other.

Neither of these policies is intrinsically valid for Argentina. Both approaches ignore the fact that Argentina's economy consists of two distinct sectors. One is the agricultural and livestock economy that competes efficiently in the world market. The other is the industrial economy which, because of its high costs, is not competitive in world markets. Unable to export enough of its products to

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earn the foreign exchange to cover its import requirements, the industrial sector must rely on the agricultural economy and external financing to obtain the foreign exchange it needs.

Populist expansionary policies generally ignore the foreign exchange bottleneck and soon exhaust the foreign exchange reserves built up under previous orthodox-minded regimes. Orthodox policies are then reinstated but have to be abandoned sooner or later because of mounting public opposition to real wage cuts, unemployment and poor business activity associated with these policies. The way out of the dilemma is to execute a coherent development strategy designed to increase industrial as well as agricultural exports, remove disincentives to agricultural production and reduce the frequency and magnitude of transfers of income between the rural and urban populations which are a basic cause of political and social unrest.

## THE PENDULUM SWINGS BETWEEN POPULIST AND ORTHODOX ECONOMIC POLICY IN ARGENTINA

For decades, the Argentine economy's performance has been poor because of economic policies that have swung like a pendulum between two opposing poles—the expansionist/populist and the orthodox or neo-classical approaches. The two principal objectives of expansionist policy are the reduction in the inequality of income distribution and the attainment of full employment. The first objective is sought by means of granting larger social benefits and generous wage and salary increases. The second objective—full employment—is sought by assuring a high level of demand. Other principal instruments of expansionist or populist economic policy include manipulating foreign exchange rates and controlling the prices of goods and services rendered by both the private and public sector to keep the cost of living low.

The expansionist periods frequently begin with an increase in real salaries, cheap credit, increased economic activity, and optimism in the industrial and commercial sector. This stage seldom lasts long. The deficit in the budget grows, the balance of trade is thrown into disequilibrium, accelerating inflation erodes real wages, and unrest develops in the labor unions. The process culminates in the exhaustion of Central Bank reserves and a crisis in the balance of payments. Expansion comes to a halt and a chaotic economic situation emerges. As time passes, the opposition of influential sectors of society increases, and finally those in charge of government economic policy are ousted, generally including the chief executive.

Although the populists admit to some errors and excesses, they tend to minimize their importance. As the principal justification of their failure, they blame the insufficiency of political power to control the key factors of the economy and the resistance of powerful national and international economic interests.

The failure of the populist program always provokes an abrupt turn toward economic orthodoxy. The power goes to economic policy makers who are strongly influenced by neoclassical economic theories that prevail in the universities, governments, and financial circles of the highly industrialized countries and in the international financial institutions. The orthodox ideas emphasize order, discipline, efficiency and balancing of the budget, as well as confidence of investors, the attraction of foreign capital, and the virtues of popular sacrifice.

In countries like Argentina and the rest of the Southern Cone, the new economic teams generally come to power in the midst of a balance of payments crisis. Their responses include large devaluations—which automatically bring about large increases in the income of the agricultural sector—a lid on increases in urban money wages, drastic monetary and credit restrictions, and an intensified effort to attract foreign capital. Invariably the first effects are a wave of business failures, increased unemployment and a fall in real wages—in short, a recession. The economic team regards these effects as a temporary, but unavoidable sacrifice that must be endured in order to put the economy on a sound basis for revival and growth for the benefit of the entire population.

In Argentina and similar economies, however, in no case has this revival and recovery materialized. The orthodox policy does achieve certain successes in the beginning. The rate of inflation, which always increases initially after devaluation, usually diminishes later on; financial capital flows in from abroad, and real salaries recover to some extent. Nevertheless, at some point in the process a crisis of confidence occurs. The flow of foreign capital is reversed. Loans that had come in from abroad begin to fall off. This results in great pressure on foreign currency reserves and a crisis in the foreign exchange market compelling the government to effect a sudden devaluation. Real wages then fall, aggregate demand falls off, the rate of inflation accelerates rapidly, and the economy again falls into a recession, usually even deeper than the previous one.

The reaction of the orthodox school to its lack of success has always been similar to that of the populists. Like the populists, the orthodox school, though it may admit some errors in the execution of its economic policy, attributes its failure primarily to not having enough political power to carry out its policies. The lack of this power, it always insists, prevented it from bringing about the improvement in public administration necessary to eliminate inefficient public enterprises and to keep wages depressed for a period long enough to generate a self-sustaining growth process.

## THE POLITICAL STAND-OFF

The pendulum swings between populist and orthodox economic policies have led many political observers to believe that what counts is not so much the nature of policy but the fact that, whatever policy is chosen, it must have enough political power behind it to give it enough time to work.

The thesis of this paper is that this view is erroneous. Although it is true that any economic policy needs political support in order to be successful, neither the populist policy nor the orthodox policy, as they were carried out in the past, would have been able to achieve their stated objectives even if they had been accompanied by total political power. This is so because neither had intrinsic feasibility. Both policies were and are condemned to failure for purely economic reasons. The lack of viability of both policies is due to the inadequacy for semi-industrialized countries of the intellectual models on which they are based—of the Keynesian in the case of the populist model and of the neoclassical in that of the orthodox mode.[1]

The determination of the cause of the stop-and-go cycles in Argentina has great political importance. If, on the one hand, the real cause is the more or less equal political strength of the populist and the orthodox schools which prevents both sides from having adequate time to carry out their respective policies, an authoritarian government should be capable of overcoming this stand-off. Regardless of the program it chooses, this authoritarian government should be able to carry out the chosen policy over all resistance, confident that in time its correctness will be proved, and its firmness will be justified.

On the other hand, if neither of the policies has intrinsic feasibility, then the disorder, the inflation, the shortages, and the cessation of foreign payments that have nearly always characterized the populist program, and the recession, foreign debt, and crises of confidence associated with the orthodox program, are not chance phenomena. Rather, they are inherent faults of the respective policies. In this case, the resistance of the affected sectors—independently of the fact that it could constitute a defense of their interests—ought to be interpreted as a healthy defensive reaction of society. And if this is so, then a goverment that aspires to give the nation an economic solution should not only be concerned about getting the necessary amount of power, but above all, should concentrate on formulating an intrinsically viable economic policy. What has been said refers not only to Argentina. The struggle between the two opposing economic policies that are divorced from reality has been reproduced in several similar Latin American countries, and the analysis of the Argentine situation can be a great extent be applied to them.[2]

## INDUSTRIALIZATION AND COMPARATIVE ADVANTAGE

Argentina belongs today to a large group of primary exporting countries in the process of industrialization. All of them initiated their economic life specializing in the production and exportation of certain primary products, in which they were highly efficient thanks to nature's bounty: fertile soil, favorable climate, or an abundance of mineral resources. In this stage, there is virtually no manufacturing industry, since such a sector cannot defend itself against international competition. The cause of the problem is the low initial productivity of the industrial sector.

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[1] The theme of the struggle between economic indeologies in Argentina is described in detail in Diamand, Marcelo, "Seis Falsos dilemas en el Debate Económico Nacional", El Cronista Comercial. January 4-20, 1971 and Doctrinas Económicas, Desarrollo e Independencia, Paidós, Buenos Aires, 1973.

[2] It is obvious that the struggle between the two opposing economic programs is not purely academic but constitutes an intellectual reflection of an intersectoral dispute concerning the distribution of income and economic power. Another aspect is that the instability of constitutional government in Argentina, the propensity of the country to move toward military coups, and the pendular political movement between democracy and de facto regimes in Argentina are also closely related to these unresolved economic conflicts. See O'Donnell, Guillermo. "Modernización y Autoriatarismo," Paidés, Buenos Aires, 1973.

In contrast to the productivity of the primary sector, industrial productivity does not depend on more or less favorable natural conditions, but is a function of the degree of development of the country. The first requisite of industrial productivity is a high density of capital—plant and equipment—in the industry itself and in the economy within which it operates. The second requirement is the mastery of technology obtained through "learning by doing."

Thirdly, industry is not a simple aggregate of activities, but rather a complex interdependent system, the productivity of that depends on management's capacity to coordinate, synchronize, and control the multiple stages involved in the manufacture of an industrial product.

Fourthly, productivity depends upon government behavior—the efficiency of basic services provided by the state, and the coherence and stability of the rules of the game that the state creates and that determine the capacity of the public and private sectors to plan and carry out long-run investments in machinery and technology.

Finally, industrial productivity depends on scale. Modern technologies of mass production are characterized by low direct costs and high fixed costs: amortization of capital plant and equipment and the employment of overhead staffs for design, engineering, marketing, procurement, production and quality control. Because of all this, manufacturing firms, in order to be really productive, must have a certain minimum volume of production.

None of the conditions, therefore, that could create a comparative advantage in favor of industry is provided by nature. Nor is comparative advantage a genetic endowment of a few lucky countries. All depends upon the degree of development of the industrial structure. In other words, a nation can become an efficient industrial economy only by means of the industrialization process itself.[3]

All of this means that in the first decades of development, industrial productivity will necessarily be very low, and at a net disadvantage compared with the primary sector which is favored by nature. To overcome this disadvantage, manufacturing industry requires protection.

## THE FREE TRADE—INDUSTRIALIZATION CONTROVERSY

Traditional neoclassical thought is opposed to this protection. According to the principle of comparative advantage, all countries ought to abide by the principles of free trade, even if for many developing countries this means renouncing industrialization. According to this theory, these countries should dedicate all of their resources to primary production and use the foreign currency earned to import the necessary industrial goods. In this way, presumably, they would assure the most efficient use of their resources and the greatest welfare for their population.

The neo-classical argument is based on a very simplified theoretical model that does not adequately reflect the conditions of the real world. In practice, the countries exclusively dedicated to primary production encounter serious economic problems not recognized by neo-classical theory.[4]

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[3] An interesting illustration of the theme of dynamic comparative advantages of industry is given by Katz, J. "Estrategia Industrial y Ventajas Comparativas Dinámicas", Cuadernos, Fundación Dr. Eugenio Blanco. Año 1. August 1983.

The first of these is the problem of employment. Even those primary activities that count on a sustained world demand, as was the case until recently with the production of petroleum, can never give employment to the entire population. In the second place, world demand is rarely maintained on a stable basis. The market for primary products generally expands much less than is needed to assure the economic growth to which the producing countries aspire. Moreover, the prices of primary products tend to be highly variable, causing the foreign exchange earnings of the exporting country to be very unstable. In the third place, it is risky to base all of the economic life of a country on one or two products because of the possibility of their source of supply dwindling or their becoming obsolete, (as with the historic cases of the Peruvian anchovy and of Brazilian natural rubber).

Finally and most important, is the dynamic quality of industrial productivity. In order to reach a high level of industrial productivity, it is necessary to begin to industrialize the country at low levels of productivity. The theory of the international division of labor, which underlies the principle of free trade, is totally static and would freeze the initially low productivity of industry in a developing country. Under the free trade scheme, the country exporting primary products is condemned to eschew the only route that at some point could enable it to have a more efficient industry and diversified exportable products. All of the preceding are very strong arguments in favor of industrialization with the support of protection, and for the disregard of the principle of static comparative advantage.

The infant industry controversy is well known, going back to the debates of more than a century ago between American and German protectionists and British free traders.[5] The United States and Germany today are industrial powers and not agricultural countries thanks to the fact that at some time in the past, the supporters of protection were able to translate their ideas into policy. In the same way, the present processes of industrialization in the primary exporting countries result from the fact that in all of them at a given moment there was a political decision to industrialize, and to make use of protection.

In light of the present problems of countries like Argentina, this decision to industrialize seems to have been less successful than the similar decision that today's industrial countries made at the inception of their industrialization. It is argued here that the problem now afflicting the industrializing countries is not that the decision to industrialize with protection was mistaken, but that this decision was implemented inconsistently.

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[4] The different reasons for industrialization are given in Prebisch, R. "Hacia una Dinámica del Desarrollo Latinoamericano," Fondo de Cultura Económica. Mexico, 1963, with emphasis put on problems of demand, and in Kaldor, Nicholas, with emphasis on problems of employment and on the dynamic nature of industrial productivity, "Exchange Rates and Economic Development," Essays on Economic Policy, Vol. II. Norton, New York, 1964.

[5] These debates can be followed in "The National System of Political Economy," written more than a century ago by Friedrich List, famous theoretician of the industrialization of the United States and Germany. "The National System of Political Economy." Longmans Green and Co., London, 1922.

Moreover, though the manufacturing sectors of Argentina and several other Latin American countries are not internationally competitive, they have greatly raised the level of employment in their countries, developed a substantial technological base and trained a skilled labor force. The root of their problem is that in the process of industrialization under high protection, they have also created a new economic model. This model, which is very little understood and quite different from that of the traditional neoclassical model that forms the basis of prevailing economic thought, has its own set of problems.

## UNBALANCED PRODUCTIVE STRUCTURES (UPS)

This new model is what I have termed an Unbalanced Productive Structure (UPS).[6] The UPS is an economy composed of two principal sectors that have very different levels of productivity: a highly productive primary sector (agriculture in the case of Argentina), that competes effectively in world markets, and an industrial sector of much lower productivity, which because its costs and prices are substantially higher than world market prices, is confined to producing mainly for the domestic market.

In general, in today's world the industrializing countries do not realize that they are working with a new and different dual sector model, and they continue to apply to this model traditional ideas that conflict with it. The result is a profound intellectual disorientation and an incapacity to overcome the problems that arise in the development of UPS economies.

The first charateristic of UPS that is not well understood is that their high industrial prices are generally attributed to industrial inefficiency. However, the inability of the industrial sector to compete internationally has relatively little to do with the efficiency or inefficiency of the industry in absolute terms. The price of any export good in dollars depends in part, it is true, on the efficiency or productivity with which it is produced. But it also depends on the rate of exchange—that is, the price of the dollar in national money—used to translate domestic prices into international prices.

In traditional economies, this rate of exchange—resulting from either the marketplace or government action—is established at a level that permits domestic goods and services to compete internationally, whatever their productivity. This automatic mechanism of exchange adaptation is what makes it possible for countries of very different degrees of productivity to complete with each other in the world market. Thanks to it, Korea, Taiwan, and Hong Kong, despite the low productivity of their industries at the beginning of their development, were able to inundate the world market with their cheap exports.

They were able to do so because they set a low value for their currency in terms of dollars thereby enabling them to bring their prices down to internationally competitive levels at a cost of depressed real salaries and a low standard of living.

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[6] The analysis of the economic model that appears in the Unbalanced Productive Structure is treated in Diamand, "Bases para una Politica Industrial Argentina", El Cronista Comercial, April-May 1969.

The lack of competitiveness of UPS like Argentina arises because the mechanism of exchange adaptation does not function properly. Since there are two sectors of entirely different productivity—the primary and industrial—the rate of exchange can adequately represent only one of them at the international level. Given that in Argentina this exchange rate is habitually based on the costs and prices of the highly productive agriculture and cattle raising sectors of the fertile pampas, the pesos into which the "pampean" dollar are converted are not enough to cover the costs and prices of consumer and capital goods manufactured for the home market. The "pampean 'dollar'" is even too low for the cotton from the Chaco or the sugar from Tucuman. This is why the prices of industrial products as well as of many regional agricultural products (i.e. those not grown on the pampas) expressed in "pampean" dollars are higher than international prices. The agricultural sector, accordingly, sets a standard of reference of exceptional productivity impossible for the rest of the country to reach.[7]

This illusion of industrial inefficiency leads to the first problem confronting Argentina and many other Unbalanced Productive Structures. The failure of their industries to compete on international markets generates hostility within some influential groups in the country itself toward the whole process of industrialization. The conviction that domestic industry is inefficient leads immediately to another adverse conclusion: Argentina's industry could be more efficient if only it wanted to be: Argentina's entrepreneurs must be incompetent or lazy because they do not compete more effictively. Protectionist measures come to be seen as instruments that create and perpetuate inefficiency; they are imposed by politicans to benefit "inept" entrepreneurs to the detriment of the rest of the population. An anti-industrial stereotype is thus sustained. Periodically, this stereotype gives rise to "efficiency" drives which not only destroy industrial productive capacity, but also thwart eonomic policies that would lead to greater efficiency.

This stereotype is founded upon false premises. The fact that domestic industrial prices in dollar terms are higher than international prices does not support the argument that industry is less efficient than it ought to be at its present level of development of the country. The only valid conclusion that can be drawn is that the industrial sector does in fact suffer comparative disadvantage in relation to the primary sector.

Given that these disadvantages are repeated in all the primary exporting countries in the process of industrialization, it is unlikely that they can all be due to the alleged deficiencies of domestic businessmen. It is more logical to conclude that these countries are all facing differences in productivity of a structural nature that always arises between the primary and industrial sectors in the first decades of industrialization. One may disagree with the decision to industrialize in disregard of the principle of comparative advantage. Once, however, a country embarks on this model of indústrialization, it should accept the disparity of relative prices between its two sectors as a fact of life in the short run and then devise an approach that will enable it to overcome some negative effects of this disparity.

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[7] Experience shows that although this reasoning coincides totally with prevailing economic theory, such as it is taught in the universities, the conclusions to which it leads are not familar to the general public, nor to the majority of economists. See "Seis falsos dilemas en el debate económico nacional", Centro de Estudios Industriales Nro. 5, Buenos Aires 1971 and "Doctrinas Económicas, Desarrollo e Independencia," Paidós, Buenos Aires, 1973.

## STRANGULATION IN THE EXTERNAL SECTOR

The main problem that UPS suffer from are recurrent foreign exchange crises. Industrialization entails a growing need for imported intermediate products, raw materials, and capital goods. In other words, the growth of industry demands a constantly increasing supply of foreign currency.

At the beginning of the process of industrialization, these new needs for foreign currency are counterbalanced by the foreign exchange savings that import substitution brings. But this substitution—which is rapid and easy when it involves only final goods—becomes much slower when it comes to raw materials and capital goods. Here huge investments are required to develop potential sources of raw materials and to achieve economies of scale for capital goods. The rhythm of foreign currency saving slows. Finally the situation is reached in which substitution barely manages to offset the growth of import products incorporating technological advances. Under these circumstances the need for foreign currency soon surpasses the foreign exchange earnings of an economy that still must rely principally on its primary sector exports.

If, as happens in the industrial countries, the new industrial sector were to export a part of its production, it would generate the foreign currency necessary to pay for the new needs for foreign exchange that it generates. But since the prices of manufactures produced in Unbalanced Productive Structures are higher than international prices, the industrial sector, unless it has special incentives in its favor, cannot export, and the primary sector remains by far the main generator of foreign exchange.

The primary sector, however, cannot increase its production and its exports so quickly and easily as the potential growth of industry would demand. Even if it could, the world market might not be there for the additional output. Accordingly, in periods of industrial expansion, the requirements for foreign currencies grow much more rapidly than their supply. The development of the Unbalanced Productive Structures is thus characterized by a chronic disparity between the demand for foreign currency and its generation. As a result, each period of expansion terminates in the exhaustion of international reserves and a crisis in the balance of payments. If the country does not possess sufficient reserves to supply its productive system, production in one way or another must decline to the level of the foreign exchange available. A considerable part of its productive capacity remains unused; the living standard of its population declines; the employment level falls; the process of investment stops—and all of this is due to the limitations imposed by the external sector.

In this manner the type of limitation prevailing in the economic system changes. The production of goods and services ceases to be restricted by the productive capacity installed, as in the classical model, or by global demand, as in the Keynesian, but rather is limited by the "bottleneck" in the external sector.[8]

The model as here described is, of course, greatly simplified. In the last two decades the treatment of industrial exports in Argentina—as in many other countries—has become more flexible, incorporating some differential incentives to stimulate them. Nevertheless, at least in Argentina, these incentives have never been considered by government as an important instrument for the economy as a whole but simply as one more concession to the inefficiency of industry. Because of this, these incentives never have been of sufficient magnitude nor have they maintained long enough to stimulate the entrepreneurial sector to make the investments necessary to modify the country's external imbalance.

In short, developing an economy with two sectors of different productivity—the primary sector, which operates with international prices, and the industrial sector, which has prices higher than the international ones—the impossibility or difficulty on the part of the industrial sector to export, the consequent disparity between the demand for foreign currency and the capacity to provide it, and a recurring tendency to develop bottlenecks in the external sector have led to repeated Argentine crises. In addition, as we shall see, these factors have promoted many other disturbances such as great devaluations, battles over the distribution of income, hyperinflation, and cumulative foreign debt.

Successfully to confront this set of problems, an appropriate theoretical model is needed. Unfortunately, neither the Keynesian nor the orthodox model is adequate for the Argentine situation. On the one hand, the Keynesian model ignores the possibility of problems in the external sector, since it was elaborated on the foundation of a simplified hypothesis of a closed economy. On the other hand, the neoclassical model postulates that external imbalances are always resolved by the market. When imbalances appear, they are interpreted as mere symptoms of internal disorder and excessive state intervention. Accordingly, without adequate conceptual models to guide them, the governments of UPS remain incapable of adopting policies that could combat these imbalances.[9]

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[8] As we shall see, bottlenecks are not inevitable, but can be eliminated with a compensatory structure of effective exchange rates. Moreover, to this basic cause of external imbalances are added many errors of economic policy that the two antagonistic ideologies habitually commit, each it its own way. Thus the phenomenon of external disequilibrium, although to a great extent of structural origin, can be overcome by appropriate policies. However, to formulate these policies previous identification of the real problem is necessary, and this is precisely what is lacking.

[9] The prevailing economic paradigm recognizes two alternative types of limitation: that set by productive capacity in the classic model, in effect when resources are fully used, and that imposed by insufficient demand in the Keynesian model, in effect when there is unemployment of resources. The possibility of a limitation exercised by the external sector is generally ignored. If and when it is given a hearing, its operation is usually analyzed in terms of the two theoretical models mentioned, which in this case have little to do with reality. The resulting disorientation resembles what existed before the Keynesian revolution in the face of the great crisis in the industrial countries. The consequences of this disorientation in the Unbalanced Productive Structures are analyzed in Diamand (1973), op. cit. The description of a similar confusion that is being repeated now at the international level because of the petroleum crisis can be found in Diamand, Marcelo, "Towards a Change in the Economic Paradigm Through the Experience of Developing Countries", Journal of Development Economics 5, pp. 19-53, 1978. The exceptions to this tendency to ignore the external limitation are given by the double gap school, by many Latin American structuralists, and by some individual economists. See for example, Chenery, H.B. and Strout, "Foreign Assistance and Economic Development", The American Economic

Continued

## POPULIST GOVERNMENTS AND THE EXTERNAL SECTOR

Until now, the coming of the populist movement to power in Argentina has always coincided with a fortuitous accumulation of foreign exchange reserves in the Central Bank, owing to a favorable international economic situation or to a previous recession. The economic expansions initiated by populist administrations have always been nourished with these reserves. In order for the expansion to continue, populist governments should have acted vigorously to counteract the gravitation of the economy toward external disequilibrium. Instead, the populist governments have generally ignored the problem, and taken actions that frequently exacerbated it. Thus, in order to maintain low food prices, populist administrations have frequently postponed devaluation and kept agricultural prices below production costs. As a result, both agricultural production and agricultural exports have been discouraged, thus aggravating the foreign exchange problem. Nor do industrial exports receive support, since, because of a series of ideological prejudices, populist governments have a strong propensity to believe there is a contradiction between production for the internal market which they favor and production for exports which they do not. At the same time, import substitution generally lags, not only because of intrinsic difficulties, but also because of the lack of new investments in basic segments of the economy. With the memories of similar crises quite fresh because they occur so often, business firms are reluctant to invest in an adverse environment marked by labor unrest, price controls that cause them losses and often dilatory state action vis-a-vis concrete investment projects.

When the foreign reserves are in danger of exhaustion, the populist administration then turn to controls to economize on foreign exchange and channel it selectively. The mechanisms used are, however, seldom efficient. Instead of a careful selection of imports based on their degree of necessity and on the extent of value added by domestic industry, quantitative quotas are generally applied. These, instead of regulating which products are to be imported, aim rather to regulate the quantities to be imported and to choose the firms which will be allowed to import them, thereby giving rise to arbitrariness and favoritism.

Finally, in an attempt to stem the inevitable outflow of foreign currency, exchange controls are imposed. These controls effectively restrain the outflow on the official market. But the quick appearance of a parallel market creates strong incentives to over-invoice the prices of imports and under-invoice those of exports. In this way a part of the foreign currency earned finds its way into the aforementioned parallel market. In addition, frequent controls on

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Review, September 1986; Taylor, L., "Macro Models for Developing Countries," McGraw-Hill, New York, 1979; Prebisch, R., op. cit.; Hirschman, Albert, "The Strategy of Economic Development," Fondo de Cultura Económica, Mexico, 1961; Seers, D., "Theory of Inflation and Growth in Underdeveloped Economies Based on the Experience of Latin America," Economic Growth Center, Yale University; Bacha, E.L., and Malan, P.S., "Brasil's Debt: From the Miracle to the Fund", Departamento Económico, Universidad Católica, Río de Janeiro, 1983; Furtado, C., "El Desequilibrio Externo en las Economías Subdesarrolladas", Trimestre Económico. No. 2, 1958. See also Hicks, J.R. The Crisis in Keynesian Economics, Basil Blackswell, 1974. The antecedents can be seen in Kalecki M., "Estudio sobre la Teoría de los Ciclos Económicos," Ariel, Barcelona, 1970.

interest rates lead to negative real rates and thus offer further incentive for domestic capital to flow abroad. In this way, the breach between the official quotation of the dollar and the parallel quotation grows even larger, and with it, the incentives to cover—invoice and under invoice, thus increasing the drain of foreign exchange.

Sooner or later the controls become ineffective, the country finds itself on the brink of a stoppage of foreign payments, and physical shortages follow. The utilization of productive capacity falls because of the country's incapacity to pay for the indispensable raw materials, semi-finished goods and machinery that must be imported. The contractionary process continues until production falls to the level permitted by the reduced availability of foreign exchange.[10]

## CONTRACTIONARY STABILIZATION PLANS

The crisis in the balance of payments generally provokes the coming to power of an orthodox-minded government. This kind of government makes use of two policies. The first consists of contractionary stabilization programs that generally follow the lines recommended by the IMF, but may not always involve a formal agreement with this institution. The second policy is to increase borrowing from abroad.

Stabilization programs always begin with an abrupt devaluation. In accordance with prevailing economic theory, such devaluation should stimulate exports, discourage imports, and in this way reestablish external balance. These results of devaluation may well be realized by highly industrialized countries, given the high price elasticity of both their exports and imports. In these countries, it is the industrial sector that accounts for the bulk of exports; therefore, the devaluation, by making a wide range of potentially available industrial products more competitive, automatically stimulates an increase in exports of those products. On the other hand, many goods that are not essential for the functioning of the economy and are imported because their price is lower than comparable domestic products are replaced by nationally produced goods.

In contrast, in Argentina and in other UPS, imports and exports are very inelastic with regard to price, especially in the short run. As far as industrial exports are concerned, their price is too far above the international level even for a substantial devaluation to make them competitive. Thus, unless industrial exports can count on important differential incentives, no significant increase can be expected from this side. With respect to agricultural exports, the growth of production necessary to increase their supply cannot come about quickly. Consequently, these exports in the short run respond very little to the fall in the exchange rate. Finally, imports to a great extent are either indispensable or take place in sectors in which their replacement by national products is difficult and complex.

External equilibrium is finally restored primarily because of the income effect, similar to the old effect of the gold standard and different from the price effect that conventional theory presupposes. The fall in the exchange rate provokes an increase in the cost of all imported products. The increase in costs is quickly transmitted to prices, first those of imported products, then to the prices of many basic raw materials produced locally and in direct competition with the imports—the "pulling" effect. Finally, since exporters of agricultural products now receive higher prices in domestic currency for their sales abroad, prices of foodstuffs on the internal market must also rise to keep these from being diverted to exports.

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[10] A more detailed analysis of these policies has been done by Canitrot, A. "La Experiencia Populista de Redistribución de Ingresos", Desarrollo Económico, Vol. XV, No. 59, 1975.

Thus, in three simultaneous ways costs and domestic prices increase sharply. Real salaries fall while "windfall" income is transferred to agriculture producers and traditional exporters. Since the rural sector has a lower propensity to consume, because of its smaller size and higher concentration of income, this transference in itself brings about a significant decline in aggregate demand.[11]

This contractionary process is traditionally then intensified by deliberate policy when the monetary authorities refuse to expand the quantity of money in circulation on a par with the increases in costs and prices. The rise of interest rates which follows reinforces the recessive effect.[12]

The resulting recession causes consumption, production and investment to decrease. Consequently, imports of finished products, capital goods, raw materials, and intermediate products decline. A surplus is then realized in the current account and the external sector returns to equilibrium, thanks to the decrease in the level of economic activity.

Monetary restriction and recession, besides reducing the demand for foreign exchange, have another purpose as well—the stimulation of agricultural production. This objective, although not possible in the short run, is feasible in the longer run, providing the relative advantages which agricultural prices gained by the devaluation can be kept intact for a reasonable length of time. This can be done only if wages and the prices of non-traded products do not move in correspondence with the exchange rate. This is possible, unfortunately, only by maintaining the economy in recession.

Finally, tight-money policy has a third simultaneous objective, which is to discourage the outflow of domestic capital and stimulate an inflow of foreign capital, a theme to which we shall return.

Thus, the equilibrating function of the traditional stabilization programs requires that monetary tightness be maintained for three reasons: as a contractionary mechanism necessary to reduce imports by curtailing production; as a mechanism to keep agricultural prices in the domestic market high relative to urban wages and the prices of the products of the urban sector and finally, as a mechanism to attract foreign capital. The resulting decline in industrial production to the point where its import needs are brought down to the available supply of foreign exchange, constitutes the indirect maner through which the external constraint works.[13]

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[11] The analysis of this effect in Argentina can be seen in Diaz-Alejandro, C.F., "Exchange Rate Devaluation in a Semi-Industrialized Country: The Experience of Argentina," MIT Press, Cambridge, Mass. 1965. For a general model, mathematically formulated, see Taylor, "Macromodels for Developing Countries" (New York, McGraw Hill 1979).

[12] For an analysis of this second contractionary effect, see Sidrausky, M., "Devaluación, Inflación y Desempleo", Económica, Vol. 14, No. 1-2, Jan.-Aug., 1968, La Plata. For a model that contains both contractionary effects—the redistributive and the monetary—see Porto, A., "Un modelo simple sobre el comportamiento macroeconómico argentino a corto plazo", Desarrollo Económico, Vol. 15, No. 59, Oct.-Dec. 1975.

## EXCHANGE INFLATION

In real life the evolution of contractionary stabilization plans does not follow the traditional or IMF schemes. Devaluation raises costs and prices substantiallly, imparting a strong initial inflationary impact. The resulting abrupt reduction in real wages and in the relative prices of products not traded internationally meets with great social resistance. The affected sectors—employers and wage earners in the industrial and service sectors—press for the recovery of their respective customary shares of the national income. Even in the midst of a recession, they always manage to get back, albeit partially, their prices and real wages, thus prolonging the initial inflationary impact. At the same time, pressures mount against the policies responsible for the recession. These pressures emanate from different sectors of the economy as well as from within the government itself, particularly the Ministries of Labor and Social Welfare, and the Presidency itself. Finally, the recession becomes difficult to enforce because of the inevitable increase of the budget deficit. In their stabilization proposals, the IMF and the conventional wisdom insist almost obsessively on the elimination of the budget deficit. Beyond the rationalizations that are employed, the real reason for this insistence is to limit monetary expansion which would reactivate the economy, and would terminate the contractionary process necessary to keep the external sector in balance.

However, one of the main effects of the decrease in economic activity is the decline in the tax base of the country, and the consequent decline in government revenues. In addition, since tax collections are always made at the prices of the previous period and spending is done at current prices, the former lag further with respect to the latter because of the abrupt increases in costs and prices produced as a result of the devaluation. It is in this way that, despite the governments' usually doing what is possible to lower fiscal expenditures, the budget deficit always grows because the fall of state revenues is greater than the reduction of expenditures. Sooner or later it becomes necessary to resort to monetary expansion to finance the deficit. The feared reactivating effect follows, and wages begin to rise. The inflationary spiral, unleashed by the devaluation, tends to continue, and the agricultural sector loses the advantages gained during the recession.

To restore the contractionary balancing mechanisms of the external sector, the government has to devalue again. In doing this, it initiates a new spiral, unleashing in this way a special type of inflation characteristic of UPS which is quite distinct from traditional demand inflations. This phenomenon, which I call exchange inflation, belongs to the family of structural inflations or "bottleneck" inflations. Its origin is the specific imbalance between the demand for scarce foreign currency and its supply, which causes a rise in the price of the foreign currency, or, stated in another way, makes a devaluation obligatory. The characteristics of this exchange inflation are: a rise of domestic prices, simultaneous with the fall in real wages, a lack of liquidity, and a decrease in the level of business activity. It also coincides with a budget deficit, but, in contrast to what occurs in demand inflation, the latter is not the cause of the inflation but rather a phenomenon induced or at the very least aggravated by it on account of the reduction in state revenues.

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[13] The antecedents are presented in Eshag, E. and Thorp, R. "Las Consecuencias Económicas y Sociales de las Politicas Ortodoxas Applicadas en la República Argentine Durante los Años de Postguerr", Desarrollo Económico, April-June 1965, Buenos Aires.

In general, inflation in Argentina has had different causes and motives at different times. But its worst outbreaks have come precisely from attempts to correct the imbalances of the external sector by means of large devaluations and the consequent transfers of income from one sector to another. This procedure, when resisted by the lagging sectors, always causes long periods of a pendulum-like struggle for income, giving rise to very violent inflationary phenomena which are extremely difficult to control. The most virulent inflations in Argentina broke out in 1959, in 1962, in 1971–72, in 1975, and in 1981, in every case after very large devaluations brought about by crises in the balance of payments.[14]

To sum up, the main difficulty that in the long run confronts contractionary stabilization programs is that they come into conflict with an income distribution acceptable to society. The pressure of lagging sectors and the virtual impossibility of avoiding monetary expansion make it difficult to maintain the sought-after configuration of relative prices. To the extent that governments try to restore such a configuration with the use of new devaluations, the result is an ever greater acceleration of exchange inflation.

It is for these reasons that in practice, just as soon as the balance of payments situation brought about by the recessive process permits, governments forsake their contractionary programs and go back again to the pattern of lagging devaluation with respect to domestic prices. In this way they produce a slight redistribution of income from the agricultural sector to the urban sectors and in particular to wage earners, and the economy is again reactivated.

As recovery proceeds, however, imports again increase. At the time, the lag in devaluation with respect to inflation causes the agricultural sector to continue losing the price advantages it had obtained by virtue of the initial devaluation. Thus two of the three mechanisms that were helping to balance the external sector during the recessive period disappear. The only balancing mechanism that remains is foreign borrowing. In this way, programs of contractionary stabilization enter into the second phase, which is that of accumulating foreign debt.

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[14] In the traditional economic model, the assumption that the market automatically eliminates supply bottlenecks through relative price changes impedes the understanding of the true nature of these bottlenecks. As a result the nature of the structural inflations originating from the exchange bottlenecks is also not taken into account. The difficulty becomes much greater still when it has to do with the specific case of exchange inflation originating from the disequilibrium between aggregate demand and the restricted supply of foreign currency. When this imbalance occurs, a level of demand perfectly suited to the installed productive capacity becomes excessive with respect to the limited supply of foreign currency. The rise in the price of foreign exchange then spreads to other prices. Despite the fact that the above is a repetitive phenomenon in Unbalanced Productive Structures and also, in the last few years in the industrial countries themselves these inflations are seldom recognized as such. More or less elaborate reference to the phenomenon can be found in Prebisch, Diaz-Alejandro, Seers, and more recently and explicity in Hicks, op. cit. For a detailed analysis, see Diamand, Marcelo, "Los Cuatro Tipos de Inflacion Argentina", Competencia, April 1971, Diamand, op. cit., 1973 Diamand, op. cit., 1978.

## THE ACCUMULATION OF FOREIGN DEBT

A common characteristic of UPS countries is the unrelenting search for investments and financial loans from abroad. Contrary to what is generally believed, the importance of these contributions does not lie in the necessity of complementing national savings with foreign capital, but in the fact that, by coming into the country in the form of foreign currency, they provide a solution for the external imbalance.[15]

Nevetheless, this recourse is never a solution; it is at most a sedative that brings temporary monetary relief to the problem but at a price of making it fundamentally worse. The loans (or the investments) enter in foreign currency. As a consequence, amortization and interest (or dividends) must also be paid in foreign currency. If these foreign contributions were invested in new export capacity or channeled into the import substitution sector they would cause an increase in the country's supply of foreign currency. In these cases they would be self-liquidating. But the most frequent destiny of foreign borrowing is to provide a temporary respite in the external sector, to delay a recession and to make possible a continuing growth of production for the domestic market. To the degree that foreign borrowing achieves these objectives, the need for foreign currency increases still more. Furthermore, the payment of interest for the new loans is added to these expenditures, thus enlarging the initial foreign deficit.

To maintain the equilibrium in the exchange market, it is necessary for loans to be renewed each time they come due. Furthermore, to compensate for the increasing interest and amortization payments the new credits and foreign investment in the country must expand continuously. In this way foreign indebtedness increases until sooner or later a new crisis in the balance of payments develops, more serious than the one the increased borrowing originally attempted to avoid. This process acquires a particularly explosive nature due to the mechanism used to stimulate inflows of foreign capital.[16]

Borrowing funds abroad takes place directly through loans to the government or through loans for the private sector. In the latter case the foreign currencies that enter the country are negotiated in the exchange market and are bought by those who need to settle their accounts with the exterior. In this way the loans are ultimately used indirectly by governments to finance imports and other disbursements in foreign currency. This procedure of using private and state enterprises as "obtainers" of foreign currency is employed in all orthodox stabilization programs. These programs, by restricting the quantity of money in circulation and credit, raise domestic interest rates, thereby compelling local firms to borrow abroad.

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[15] Here again the postulate of automatic external equilibrium of the prevailing industrial country paradigm erases the essential difference between foreign capital in the role of currency and foreign capital in the role of provider of savings. Thus, it is very difficult to visualize the inconvertibility of national savings into foreign currencies that occurs in countries with balance of payments problems. Consequently, because of this inconvertibility, the impossibility of repayment of the debt and its servicing cannot be comprehended either. The result is a highly imprudent and irresponsible management of foreign debt. The antecedents of the confusion can be seen in Keynes's famous article about the German transfers. See Keynes J.M., Ensayos sobre Teoria del Commercio Internacional El Problema de Transferencias Alemanas, "Fondo de Cultura Economica, 1953. For the analysis of the problem in the Unbalanced Productive Structures, see Diamand, op. cit. 1970 or Diamand op. cit., 1973.

[16] For the mathematical analysis of the capital market in those conditions, see Frenkel, R., "El Desarrollo Reciente del Mercado de Capitales en la Argentina", Desarrollo Económico, No. 2, 1980.

Since the increase in real interest rates has a contractionary effect, the procedure perfectly suits the first phase of stabilization programs in which the reduction in general economic activity is sought after in order to reduce imports and to discourage wage increases.

But as orthodox administrations, ceding to political pressures or to the effect of monetary expansion that they cannot avoid, enter the second stage of their stabilization programs, interest rates go down as a result of monetary and credit expansion.

Accordingly, then, the incentives for attracting foreign capital disappear. Nothing remains of three balancing effects on the external sector that were key features of the initial stabilization effort—the fall in imports due to the recession, the increase in agricultural prices, and the attraction of capital. However, the problem is temporarily overcome thanks to the devaluation lag.

## THE DEVALUATION LAG

To understand how the devaluation lag works, one must keep in mind that the incentives for borrowing abroad are not determined by real rates of interest as such, measured as the difference between nominal rates and inflation. What is important is the difference between domestic nominal interest rates on one side and, on the other, the sum of (1) international rates on the dollar market, and (2) the rate of devaluation. Thus, high incentives for borrowing can be provided either by raising domestic interest rates to high levels in real terms, or, alternatively, by decelerating the rhythm of devaluations with respect to inflation. The former procedure is characteristic of the first contractions of stabilization programs. For the second stage, however, in which the goal of recession is being abandoned, it is not longer adequate. Delaying devaluations seem to provide a solution. As was said before, in the second stage of stabilization, the devaluations begin to lag behind inflation as a result of pressure for expansion exerted by society.

Taking advantage of this lag to attract foreign capital seems to be an ideal remedy for the foreign sector disequilibrium. In offering very high yields, this lag induces the massive inflow of foreign investment into the country. The reserves in the Central Bank increase sharply. Real wages recover, and the level of business activity rises. Confidence in the economy develops, and a general feeling of prosperity obtains. However, in order to maintain these incentives, the devaluations have to keep lagging behind the rate of inflation. The local currency becomes progressively more and more overvalued. This overvaluation has very high economic costs, since it discourages exports and encourages imports, thereby increasing the external deficit and creating a still greater need for foreign capital to compensate it.

Another usual characteristic of this phase of the cycle are the "efficientist" policies. As we have seen before, the decision to industrialize, made several decades ago in Argentina, was never accepted by Argentine society as a whole and particularly by the agricultural and ranching interests and circles dependent on or influenced by them. These groups are convinced of the validity of the sterotype of industrial inefficiency and of the fact that this inefficiency can only be overcome by greater international competition. For this reason the temporary abundance of foreign exchange always encourages attempts to reduce protection and to eliminate the government's incentives that could stimulate industrial exports. This "efficientism" stimulates an increase in imports and reduces the volume of nontraditional exports, adding to the drain of foreign exchange which originated in the devaluation lag. In sum, the country deliberately increases its external disequilibrium and its indebtedness for the sake of a claimed increase in industrial efficiency.[17]

Once the process of exchange rate lags is initiated, it is very difficult to halt. The longer it lasts, the greater becomes the deficit on current account of the balance of payments; the larger this deficit is, the greater is the need for new foreign capital to cover it. For this reason, the necessity is also greater not to disturb the pattern of exchange lag that makes this capital flow possible.

The process ultimately becomes very unstable. The continuity of the flow of foreign loans depends on the confidence of foreign lenders in the ability of the country to repay them. As the same time, so that this capacity can be maintained, an ever greater flow of loans is necessary.

In the final stages there is a slowly growing awareness that the indebedness is getting out of hand. For this reason, an increasing number of firms and individuals of the private sector, foreseeing an imminent maxi-devaluation, begin to send funds abroad. As this capital flight also has to be covered, it is necessary to borrow even more foreign funds. Thus the pressure increases on the "obtainers" of loans, principally, at this stage, the public sector enterprises, to obtain more foreign currency. Business confidence declines further. A number of short term loans, supposedly renewable, are not renewed. The Central Bank is obliged to begin selling its reserves. The lack of confidence increases, the rate of renewals decreases even more, and capital flight accelerates. Finally the process culminates in a run on the exchange market which can within a few days plunge an apparently prosperous country into a profound crisis. The government feels obliged to impose a new and abrupt devaluation. There remains nothing to do but undertake a new contractionary stabilization program. The whole process is thus repeated, but with a higher foreign debt level, the need for a more drastic contractionary program and a more pronounced fall in production.

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[17] The cycles of foreign debt accumulation recurring in the Southern Cone in recent years, were sanctioned at the theoretical level by the monetary approach to the balance of payments. This approach involves the dismantling of protection for the sake of greater efficiency. It thereby acquires a second significance, since it is thus seen as a presumed mechanism of price stablization. The mechanism becomes necessary for the scheme to be complete at a theoretical level—although again without any relationship to what happens in reality. See Diamand, M. "La Marcha de la Economía", in Revista IDEA, No. 36, July-Sept. 1980 and Foxley A., "Enfoques Ortodoxos para el Ajuste Económico de Corto Plazo; Lecciones de la Experiencia y Temas de Investigación", CIEPLAN, Mimeo, Chile, 1982.

## THE PENDULUM AND VICIOUS CYCLES

There is a certain parallelism between the policies of the populist and orthodox policies. The former neglect private investment and the external sector and endure as long as the foreign exchange reserves hold out. Orthodox policies are initiated when there are little or no reserves, and the country is on the brink of a cessation of payments. In the short run these reserves are rebuilt at the price of recession and as a result of the inflow of new credits. In the longer run, however, orthodox foreign sector policy fails because its mode of stimulating the inflow of foreign exchange becomes incompatible with recovery as well as with an acceptable level of real wages. Finally, foreign loans and investments remain as the only source of external financing, and expansion and growth continue only as long as the country's capacity for foreign indebtedness can sustain them.

The prospects of success of both the populist and orthodox approach are not very encouraging. On the one hand, populist policies come afoul of the external sector. On the other hand, orthodox policies that aim to reform the external sector by reducing real wages and demand, lead to recession and stagnation. Thus it can be seen that the Argentine pendulum really has causes much much deeper than the so-called political stand-off. The cycles of expansion and recession are generated by the balance of payments problems that are inherent in both the populist and the orthodox approaches.

The worst aspect of the situation is that this pendular process is not static: It becomes increasingly unmanageable because of at least three types of vicious circles. The first of these is the growth of foreign indebtedness. Between 1959 and 1982, Argentina's external debt grew from $500 million to nearly $40 billion in nominal terms. In terms of 1975 dollars, this is about equivalent to a growth from $1.8 billion to $23 billion. At the same time, interest payments grew rapidly, adding to the basic external disequilibrium which each successive economic team had to face, and which it tried to solve by borrowing even more.

The second vicious circle arises from the conflictive character of development. The continuous attempts to resolve the problems of the external sector through massive transfers of income provoke sectoral defense reactions which become more and more violent and lead to higher and higher rates of inflation, which themselves later become autonomous causes of economic chaos and political disorder.

The third vicious circle develops in regard to industrial efficiency. Industrial productivity or efficiency depends fundamentally on the degree of development of a country. After several decades of sustained development, the initial difference in productivity between agriculture and industry should have disappeared or at least been greatly diminished. But because of erratic development caused by recessions and the destruction of industrial capacity during "efficientist" episodes, instead of sustained progress, Argentina, for every three steps forward has fallen back two. In this way, after forty or fifty years the country has advanced to a point which should have been reached within ten or fifteen years. The problems of the differences in productivity between the two main sectors and the inability of the industrial sector to compete internationally remain unsolved. The classic question of the anti-industrial sectors, "how much longer are we going to support industry by maintaining it artifically?" appears validated. Anti-industrial measures find greater justification and successively fall into another vicious circle, apparently without solution.

## THE PRESENT SITUATION AND PROSPECTS FOR THE FUTURE

What contributes most to the continuation of all these vicious circles is orthodox economic policy. The last stage in the accumulation of the debt of 1978/81 which occurred in the second phase of the contractionary stabilization program initiated in 1976/78, is very illustrative. The model followed was conceptually the same as those of similar periods in the past, but during the 1976/78 period it had an intensity and destructive effect never seen previously in Argentina. On no previous occasion had there been such a wholesale dismantling of protective mechanisms and of incentives to nontraditional exports. Never before had Argentina experienced such a pronounced exchange lag or such a generalized destructive, effect on internal productive activity. In short, orthodoxy had never before gone to such extremes.[18]

There were several reasons for this virulence. The first was the strong concentration of political power, which permitted an authoritarian government to impose a particularly fanatic conception of the economy on a virtually defenseless society. The second was the great abundance of easily obtainable funds in the international financial market generated by the oil surplus which facilitated and stimulated a practically unlimited expansion of debt. The third was the international prevalence of monetarist and free trade ideology that reinforced the local orthodoxy. This coincided with the pressing need of the industrialized countries both to pass on to others their trade deficits which had also been caused by the manifold rise in world oil prices and at the same time to recycle the funds of the oil exporting countries which were being deposited in their financial institutions.[19]

The first outcome of this period was the unprecedented growth of the foreign debt which rose from some $10 billion in 1976 to nearly $40 billion in 1982, equal to about five years of exports (in terms of 1975 dollars, the debt rose from about $9 billion in 1976 to about $23 billion in 1982).

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[18] For an exhaustive investigation of the exchange lag incurred, see Llach J., "Los Precios de una Década: El Tipo de Cambio Real y los Precios Relativos en la Economía Argentina: 1970-1982" in Estudios; Año V, No. 24, Oct/Dec 1982.

[19] The apparently new monetary approach to the balance of payments is nothing more than an elegant rationalization of phase II of the stabilization programs, which in practice have been applied for decades (thus, the period 1978-81 in Argentina has great conceptual similarity to the period 1960-62). For the reasons of the failure of the monetary approach, see Foxley, (op. cit.) Schydlowsky, "Argentina's Macroeconomic Prospects as of Early October", mimeo, Center for Latin American Studies, Boston University, 1979 and Diamand (1980).

It is appropriate to emphasize that the accumulation of Argentina's debt stands in sharp contrast to the way Brazil experienced a massive increase in its foreign debt. Brazil's debt grew largely because it had to pay a sharply increased oil import bill and to pay for the increased imports of other goods needed to sustain its high rate of growth. The Argentine experience constrasts also with that of Mexico which contracted enormous debt to carry out excessive investments. Argentina imports almost no petroleum, and until the end of the period counted on favorable terms of trade. Nor was its indebtedness increased in order to finance growth, since the country's production, particularly its industrial production, declined. Argentina incurred debt above all to compensate for the growth of imports and the decrease of exports provoked by "efficientist" policy.[20]

One of the fundamental arguments in support of this policy during this period was that it would put an end to the chronic inflation that has plagued Argentina for decades. Instead, the inflation rate rose again dramatically during this period, from 81.9% to 146.3% annually.

Finally, in reference to increases in efficiency, which was another of the government's rationalization for its program, the result could not have been more disastrous. The growing displacement of national goods by imports restricted the market for domestic industry, forcing sharp reductions in the scale of production and thereby increasing the burden of overhead costs. The rules of the game became chaotic, destroying the possibility of advance planning and discouraging productive investment. A large part of the country's capacity for import substitution was destroyed. The high degree of industrial integration that had been achieved before was sharply reduced. Entire areas of domestic production were abandoned. Research laboratories went out of business, and local technological innovation fell off sharply. The few exports of manufactured goods that had met with some degree of success in world markets fell off as government incentives were eliminated. Foreign markets for non-traditional exports, so laboriously won over the years, have to a great extent been lost.

Industrial enterprises, subjected to the increasingly unbearable pressure of international competition, continued accumulating ever greater losses. To cover them, they had to go further into debt. Those who did this in national currency suffered the impact of variable, and in the last stages, very high positive real rates of interest that progressively decapitalized their firms. Those that became indebted in foreign currency suffered the decapitalizing impact of the multiple devaluations with which the cycle culminated. The result was a vast deterioration of the country's industrial enterprises and the disapperance of many of them. In short, industrial efficiency, which always depends on the degree of utilization of productive capacity, the size of the market, the rhythm of technological incorporation and investments, fell sharply; and a substantial part of the machinery of installed equipment was converted into scrap metal.

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[20] The gross national product of 1982 fell almost to the level of 1973, while the per capita GNP went down about 12% with respect to the same year.

As to future prospects, the experience of four decades seems to condemn Argentina to repeat the same cycle of expansion and recession, increasingly indebting itself in the process and growing but little and in spurts, at that. Moreover, if Argentine society's attitude toward its economic problems doen not change, even this bleak outlook may turn out to be overly optimistic. The severity of the problems confronting Argentina as a result of its many failed programs and a prospect of slow growth of the world economy, may not permit even the customary Argentine economic pendulum to remain in motion.

For the first time in Argentine history, populist policymakers are about to take over the reins of government without an ample reserve of foreign exchange and with half of the exports committed to the payment of interest on the debt.[21] For the first time in Argentina's history, populist policymakers will lack the initial margin of maneuver on which their predecessors always counted on. Moreover, because international lenders are now very wary as a result of the debt crisis, it is now almost impossible for debtor countries like Argentine to go deeper into debt and even governments committed to orthodox stabilization programs lack their usual ample access to foreign exchange lines of credit.

All this means that for the present, the pendulum has come to a halt. Populist expansionist policies are out of the question, because of the lack of foreign exchange reserves, and economic orthodoxy is ruled out because of the inability under present circumstances of the Argentine government and the private sector to attact foreign credits or investment. If Argentina is not to remain condemned to permanent stagnation, it will have to learn to overcome the foreign exchange bottleneck that periodically strangles its economy.

Because of the wealth of its natural resources and its skilled manpower, Argentina does not need miraculous cures. What it needs is the realization that virtually all the serious problems in the economy are a direct or indirect consequence of the foreign exchange bottleneck and that this problem should finally be given the importance it deserves. Public opinion must be mobilized in support of a sound strategy for producing foreign exchange and for using it wisely.[22]

The task does not end there. Once the external bottleneck is overcome, it will be necessary to reactivate the economy, slow down the inflationary process by means of an incomes policy, stimulate long-run growth, reduce the budget deficit and promote an industrial policy designed to make industry increasingly efficient.

## THE BASES FOR A NEW ECONOMIC POLICY

Action with respect to the external sector should be based on the following strategies: (1) promotion of industrial exports; (2) stimulation of agricultural production and exports; (3) a sound, selective policy for imports, and the aggressive promotion of import substitution; and, finally, (4) the rational management of the external financing and the internal financial system. Abandoning the ancient vice of eternally debating the alternative merits of different strategies without adopting any, it is necessary to adopt all of them at the same time in a very intensive manner.

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[21] As stated in the footnote on the first page of this article, this essay was writen in late 1983 as the Alfonsin government was about to take office.

[22] See Schydlowsky, D. "Containing the Costs of Stabilization in Semi-Industrialized LDC's", Center for Latin American Studies, Boston University, Discussion Paper Series No. 36, 1979.

Although in some cases the cost in terms of other economic variables may seem high, one must keep in mind that, once nonessential imports are eliminated, the marginal coefficient of imports in Argentina hardly exceeds 10%. This means that for every dollar earned or saved, about ten dollars worth of domestic production can be put to work. In other words, the necessary cost of obtaining each additional dollar of exports or of substitutions should always be compared to the alternate cost that the loss of about ten dollars of domestic production would signify.

## The Promotion of Industrial Exports

The high prices of Argentina's manufactured products which impede their exportation are the result both of the lower productivity of the industrial sector relative to the agricultural sector and of the fundamental and key factor that the exchange rate is based on agricultural productivity. To protect domestic manufacturing production, taxes or import tariffs are levied which, together with the basic exchange rate, function in reality like a system of multiple exchange rates. But the serious defects of these pseudo-exchange rates is that they function only for imports. For industrial exports, the nominal exchange rate based on a parity corresponding to the primary sector continues to prevail. Thus, industrial products, whose lower productivity is recognized by import exchange rates that are much higher than the nominal rates, are exported on the basis of an exchange rate that is not appropriate for them because it is set for the purpose of moving only efficiently produced primary goods. This exchange asymmetry militates against industrial exports and is responsible for the chain of events that culminates in Argentina's economic crises and stagnation.

The choice of determining the nominal rate of exchange on the basis of the more productive sector, which seems "obvious" and "natural," in reality constitutes the traditional tool for preserving the equilibrium of the productive structure. When this criterion is adopted, all activities which have a productivity relatively lower than that of the sector chosen as the basis of the exchange system will have prices higher than those on the international market and—except in the case of a deliberate protection—will be unable to survive because of world competition. In other words, the criterion of making the exchange rate coincide with the most productive sector is the conscious or unconscious expression of the intention to assure fulfillment of the principle of comparative advantage.

The industrial development of countries like Argentina requires, at least initially, the deliberate abandonment of the principle of comparative advantage and the promotion of the relatively less efficient manufacturing sector. To continue to hold to an exchange rate system which has the implicit goal of preventing industrialization is a monumental contradiction into which most of the primary exporting countries fall in the process of industrialization. It is this contradiction, not industrialization per se, which leads to the so-called dead end of import substitution policy—scarcity of foreign exchange and recurrent balance of payments crises.[23]

Thus, while the political will favors industrial development, the policies taken over from the developed countries militate against industrialization. To make this industrialization possible, industrial exports, services and non-Pampean agricultural products must have rates of exchange that bear a reasonable relationship to the effective exchange rates governing imports.

The most direct form of achieving this is to maintain the nominal exchange rate at a higher level than that which agricultural production requires, to concurrently reduce import duties, and to return to the "pampean" exchange rate by means of appropriate taxes on traditional exports. A second variation is to reconstruct a system of multiple export exchange rates by means of appropriate fiscal reimbursements. Still a third variation is to utilize a system of generalized drawback, which compensates for the internal high level of prices of raw materials and intermediate goods—including those which are of local origin.

Each one of these procedures has certain advantages and disadvantages from the point of view of internal political considerations and external relations, the latter particularly due to the country's vulnerability to charges of dumping. The important thing, however, is to understand the necessity for differential exchange rates, whatever the exact details of their structuring may be.

The difference between this and the systems that have previously been tried in Argentina is that the other systems were only reluctantly and fitfully applied since they lacked a sound, conceptual basis. The incentives should not be offered in ad hoc way as they have been offered in the past, but rather as an integral part of a deliberate promotional program that takes into full account the difference in productivity between our agricultural and our manufacturing sectors, the need to compensate for this difference, and the overriding importance of overcoming the foreign exchange problem. The export incentives should not be short-lived but assured for at least the medium term.[24]

One objection to governmental export promotion is that the government's fiscal resources are too limited to finance an ambitious incentive program. The fiscal expenditure, however, necessary to obtain an additional dollar of exports is much less than the decline of the government's revenues caused by the recession that inevitably develops when this marginal dollar of foreign exchange is lacking. In other words, the state's financing of an export incentive system is not an ordinary budget expenditure but an investment that makes possible the expansion of the economy and produces additional revenues for the government.[25]

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[23] For the analysis of the exchange system, see Diamand, M., "La Estructura Productive Desequilibrada y el Tipo de Cambio", Desarrollo Económico, April–June 1972.

[24] See Schydlowsky, D. "From Import Substitution to Export Promotion for Semi-Grown Up Industries", Development Advisory Service, Harvard University, 1967; Diamand (1973); and C.A.B.T.A., "Proyecto de Modificaión de la Estructura Arancelario-Cambiaria", Cámara Argetina de Industrias Electrónicas, Buenos Aires, 1966.

[25] For the fiscal effect see Schydlowsky, D. "Short-Run Employment Policy in Semi-Industrialized Economies", Development Advisory Service, Harvard University, 1967 and "Fiscal Policy for Full Capacity Industrial Growth in Latin America", Center for International Affairs, Harvard University, 1971.

An efficient export promotion scheme must meet two requirements: First, it should generate a reasonable net profit in terms of foreign exchange for every peso invested.

Second, over-generous incentives should be avoided. The producer/exporter must not receive on a net basis a higher price in the national currency for his exports than he does for what he sells in the home market. Otherwise, if the goods exported sell at higher prices abroad than they sell at home, the prices of these goods in the home market will rise as a result of the competition between the two markets.

### INCENTIVES FOR AGRICULTURAL PRODUCTION AND EXPORTS

The second course of action should be the expansion of traditional agricultural output. In Argentina, agricultural production operates on the basis of increasing costs: the first ton of wheat per hectare enjoys all the natural advantages of the very fertile central plains (pampas) and good climate and has a very low cost. However, if one wishes to produce two tons, the second ton requires investments, special care, fertilizer and more intensive management, all of which mean higher costs. This is also true of wheat and other grains produced on marginal lands. To increase production the price must rise enough to outweigh the additional costs entailed in producing the second ton. When this happens, however, the intramarginal producer who did not expand his output obtains a windfall because his costs have not risen. The global increase of agricultural prices thus has two effects. On one hand, it gives a greater and economically useful incentive to additional production. But on the other, it leads also to a windfall transfer of income to the nonmarginal producers at the expense of real salaries and wages of the urban sector, which fall as a consequence of this rise of prices. The challenge to Argentina's policymakers is to design a system that would separate the two effects, rewarding marginal or additional agricultural production without gratuitously rewarding production that would have taken place anyway.

This separation can be achieved by combining a substantial increase in agricultural prices with a land productivity tax. This tax would replace all other agricultural taxes including taxes on profits. Let us suppose that the normal extensive output of a "pampean" hectare is a ton of wheat that today, say, costs one hundred pesos. By devaluing the pampean dollar (or by lowering export duties, if they exist) this price would rise, say, to 150 pesos. But simultaneously a tax on pampas land of 50 pesos per hectare would be imposed. The first ton of wheat would then obtain a net income of 150 pesos minus 50, or, in other words, the same 100 as before. In contrast, however, the second ton would yield 150 pesos net, since the tax would already have been paid for the first ton. One might also vary the land tax in accordance with the productivity of the land, thus giving a greater incentive to non-pampean production.

The first part of the plan, accordingly, would aim at seeing to it that the increases in agricultural prices would not transfer windfall gains to the agricultural sector. The second part of the program would consist of seeing to it that agricultural prices do not cause a fall in real income of the urban population. That is, the revenue from the land productivity tax would be transferred back to urban consumers. One way of doing this would be to reduce retail sales taxes, turnover taxes and other taxes imposed on manufactured products and services of widespread consumption, thus lowering their prices. Another way of keeping urban real incomes from falling would be to lower social security contributions. In practice, it would probably be suitable to use a mixture of the foregoing strategies. In this way, despite the increase in food prices, a fall in the buying power of wages would be avoided.

To sum up, effective incentives to increase production can be devised without precipitating the massive transfers of incomes away from the urban population which are socially so unsettling and economically so destructive. The tax reform would also discourage the idling and under-exploitation of good land. The entire plan would have an important additional effect by modifying relative prices. Agricultural prices would go up in relation to the prices of industrial goods, and the dollar would be set closer to the parity of the industrial sector. The imbalance between the two sectors would be reduced, and with it the dispersion of differential rates of exchange both for imports and exports.[26]

## SELECTIVITY OF IMPORTS AND IMPORT SUBSTITUTION

The increase in the supply of foreign exchange must be accompanied by better criteria for its allocation among competing uses. Some imports are more essential to the functioning of the economy and the welfare of the public than others. At the level of industrial inputs and capital goods, the selection process is complex, and business firms should have a large role in determining import priorities.

The instruments of a rational import policy should be import duties and prohibitions of some imports. Rationing by means of quantity quotas should be avoided at all costs. The rationing power to determine what firms should have import rights lends itself to favoritism, arbitrariness and a rise in the domestic prices of rationed products. In other words, the system of selection should limit itself to determining what should be imported and not who can import it or how much they should be able to import.

With similar methods, import substitution should be encouraged so as to achieve a sharp reduction in the ratio of imported inputs to total inputs (the import coefficient). Although substitution opportunities are supposed to have diminished greatly, there are still many goods that Argentina does not produce which it could manufacture, if potential producers were given adequate encouragement. Although import substitution efforts in Argentina have been quite intense over the years in some sectors, in general they have been rather haphazardly and sometimes perversely applied. Argentina governments have wavered in their criteria sometimes helping enterprises whose costs of production are very far above world prices and neglecting those that with a little help could quickly compete internationally. Also, periods of extreme restrictions that sometimes even made prohibitive the imports of indispensable raw materials have alternated with periods in which under the banner of "efficientism" imports were totally liberalized, and "de-substitution" brought about of sectors where considerable success in substition had been achieved.

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[26] Thus an exchange scheme based on a land productivity tax can complement a scheme with export duties, allowing the latter to be smaller, or can replace it entirely.

The most recent period of "efficientism" was the most extreme in Argentine history, leaving a very low general level of protection and little differentiation in the level of that protection as among the different stages of production. In addition, the experience left the business community shaken and with little confidence in the ability of governments, present and future, to abide by a rational substitution policy.

The productive capacity exists, but appropiate protection is lacking or exemptions and exceptions now in force make it inoperable. To revitalize the substitution strategy, the first step is to structure a coherent system of protection. Realistic limits should be set to the costs of substitution, compatible with the current average level of industrial costs and prices, and the substitution of all imports possible within that limit should be energetically promoted.[27]

The foregoing implies basing import duties on rational criteria. For example, a coherent tariff system would differentiate duties according to the stages of production. Accordingly, lower tariffs would be set on raw materials while high tariffs would apply to technically complex finished products. Moreover, clear rules of the game should be established for granting protection for new import substitution activities.

A change of policy is urgent with respect to imports by the public sector, which are mostly capital goods. Generally, the practice in Argentina has been for the government to buy equipment domestically only if the supplying firm has already compiled a satisfactory record of performance in producing the required item. Many national firms, however, have never had a chance of becoming eligible because the state enterprise may be the only market for the product. To break this "Catch-22" situation, the government must encourage its procurement officials to make a deliberate effort to develop national sources of supply.

This means assuring foreseeable and sustained demand by deliberate planning, establishing cooperation between the provider and the state buyer, selecting technologies in terms of their availability in the country, creating a favorable predisposition on the part of the state buyer to parcel out large turn-key projects to domestic firms. Indeed, one of the most important goals of the policy of import substitution is to bring about such a change in attitude on the part of government agencies and state corporations.

## RATIONAL MANAGEMENT OF FOREIGN CAPITAL

With respect to foreign capital a distinction should be made between risk capital and financial capital. Risk capital plays a double role. On the one hand it fulfills the role of investment capital. On the other, it brings in foreign currency. In the long run, however, it always creates greater obligations in foreign currency arising from the imports of raw materials and other inputs for manufacturing, payments for technology, technical assistance, patents and trademarks, amortization, interest and profits. As far as the balance of payments is concerned, foreign investment as traditionally managed is a transitory palliative that in the long-run can magnify the original problem of scarcity of foreign exchange. To prevent this, foreign capital should be channeled toward the expansion of activities that directly or indirectly generate foreign exchange.

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[27] For a more precise definition of admissible cost of substitution, see Diamand (1973, op. cit.).

With respect to financial capital, Argentine history shows that when foreign loans are contracted without at the same time adopting basic measures to increase exports and substitute imports, the palliative is confused with a cure, and the country embarks upon a course of accumulating debt which within a short time explodes in the form of a new foreign exchange crisis. For this reason, foreign financial capital ought to be reserved either for emergencies in the external sector or to anticipate the inflow of foreign currency until simultaneous measures of export promotion bear fruit.

During these emergencies, internal financial management that encourages the inflow and retention of foreign capital is necessary. But this imperative is not limited to emergencies. It is vital, although in a less intense form, even when the country can do without foreign capital, to deter the flight of domestic capital. Assuming a system of free exchange, there are only two ways to accomplish this. The first is to maintain the real domestic rates of interest at a level at least equal to the real international rates plus the country risk premium as the saver perceives it. The second is to adopt lower rates of interest together with the exchange devaluation lag that compensates for the difference.

Nevertheless, for the measures of import substitution and promotion of exports to be effective, the basic rate of exchange, once established at the appropriate level, ought to vary at the same rate as domestic inflation minus the international inflation rate. Thus, to avoid the cumulative growth of external debt, the systematic use of the exchange lag to attract or retain foreign capital should be rejected.

In this way in a system of free exchange, the objective of preventing the outflow of capital imposes a strong connection between domestic and international rates of interest. Given the wide spread between borrowing and leading rates in Argentina and the wide margin of risk perceived by investors, the equation mentioned previously leads to strongly positive real rates of interest, incompatible with expansion of demand and the reactivation of the economy.

For this reason, populist governments always resort to exchange controls as a method of isolating domestic interest rates from international rates. Such controls generally permit domestic rates to decline to some extent for a while. But the domestic financial circuit continues to be associated with the foreign circuit through the parallel foreign currency market. This market, at the same time, is connected to the official one by means of manifold over- and under-invoicing. Through these practices, the market influences the volume of foreign currency that flows into the Central Bank, the parallel price of the dollar and indirectly, also, the domestic prices of exportable products.

The foregoing indicates that, even with the existence of exchange controls it is impossible to peg the domestic interest rate in total disregard of external rates. When the domestic nominal rate is much less than the international rate mentioned previously, the outflow of capital through the parallel market and the consequent rise in the exchange rate of the parallel dollar become uncontrollable. Expectations of further depreciation of the peso increases the outflow of capital until it eventually pulls the official dollar along with it.

This margin can be widened. One factor restricting the margin is the risk perceived by investors. If they are persuaded of the stability and coherence of the policy, then the higher will be the level of confidence and the lower will seem to be the risk. In the second place, the separation of domestic from international rates can be much greater, when there is opportunity for profitable domestic investment in the country. This implies economic expansion, favorable expectations for the future, and finally, a tax structure that favors investment and profitable reinvestment.

With the same goal of providing incentives for keeping capital in the country, it is necessary to pursue strategies for increasing the domestic savings rate. This can be done by indexation so that savings and their yields will not be less than the prevailing foreign yield. It is also necessary to avoid arbitrary taxes on financial capital or taking measures that can create uncertainty in financial markets.

## THE FOREIGN DEBT

Even supposing total success in the implementation of a policy to create and save foreign currency, the seriousness of the foreign debt and of the limitations that payment of the interest would exercise on the level of domestic activity make necessary an urgent renegotiation of foreign loans. This refers not only to the renegotiation of the debt per se, which is more or less automatic, but also to a large part of the interest. Here another difficulty presents itself, not because the renegotiation is particularly difficult as such, but because it comes with conditions on the part of the creditors which affect the future economic policies of the country. The institution charged with formulating these conditions and verifying compliance with them is the IMF.

The conditions can be subdivided into two large categories. First, there are the contractionary measures which we have already analyzed. Second is the "efficientist" ingredient that consists of reducing protection, decreasing differential incentives for industrial exports, the elimination of exchange restrictions, and so on. Speaking in terms of multiple exchange rates, the general IMF requirement is that the country reduce the dispersion of these rates as much as possible and preferably to a single rate. This is exactly the opposite of the policy for the external sector that we have proposed. Our policy is based on the explicit recognition of differential productivities in the Unbalanced Productive Structures, and therefore, calls for multiple exchange rates. Is it possible to make the policy we wish to implement compatible with the demands of the IMF?

I am convinced that this is perfectly possible. What is needed is a thorough understanding of both kinds of needs. The first objective of the Fund, as the representative of the international commercial lending institutions is to assure the capacity of debtor countries to pay the interest on the outstanding debt. But, since the Fund from its inception has had a strong ideological commitment to freedom of international trade and to the principle of comparative advantage, it can not propose programs based on multiple exchange rate systems. This leaves contractionary stabilization plans and increasing foreign undebtedness as the only alternative. The Fund's commitment to international free trade also compels it to push for additional "efficientist" requirements, which always entail a pressure for unified exchange rates.

But these demands work in such a way that for many countries like Argentina they defeat the basic aim of the Fund, which is to ensure the ability of debtor countries to repay their loans. The more the mechanisms for protection and encouragement of non-traditional exports are abandoned, the greater will be the increase in imports and decrease in exports of these products, and the deeper the recession necessary to obtain the sought-after surplus of foreign currency. That is, the greater the degree of "efficientism," the more difficult it is to maintain in practice the contractionary mechanisms necessary to compensate for the loss of foreign currency.

In its official doctrine, the Fund totally denies that there is a contradiction and uses neoclassical theory to demonstrate that its measures for liberalizing foreign trade, by reestablishing the functioning of the market system, help balance rather than unbalance the foreign accounts of UPS. Underlying this rationale is a failure to appreciate that UPS are in important respects different from the economies of industrialized countries.

Nevertheless, at the working level of governments, the officials of the international lending agencies are conscious of the difference in structure between industrializing and already industrialized countries. In practice they often abandon their "efficientist" ideological principles and do not insist on contractionary policies if they are convinced that their priority objective, which is to assure a country's ability to pay, will be fulfilled.

Given the official weight of dogma, however, unorthodox initiatives can never originate with the IMF, but must be made by the negotiating officials of the borrowing country. Of course, to have any chance of approval, the borrowing countries must present coherent and technically sound proposals. Experience shows that when this is done, the borrowing countries actually have great latitude for managing their economic policies.

Unfortunately, experience also shows that innovative stabilization policies are rarely presented to the international agencies by countries of Unbalanced Productive Structures. Argentina is a clear example of where there exists a total confusion of ideas with respect to the foreign debt and the way to deal with it, stemming from the false dilemma of orthodox versus populist ideology.

The officials making up Argentina's orthodox economic cabinets not only fully support the "efficientist" requirements of the Fund but often carry their enthusiasm further than even the Fund's officials may want to go. At the other extreme, the exponents of populist ideology usually reject the contractionary policies demanded by the IMF. They do so, however, within a frame of reference that tends to ignore the external sector and disregards the need for achieving equilibrium in a country's balance of payments. That is, the populists reject recession, as a way of correcting external disequilibrium but do not propose a coherent alternative policy.

If Argentina's future democratic government breaks with these precedents of the past and formulates a coherent program for expansion together with an array of measures in the foreign sector to support it, it will not only have a guide for its own action, but will also demonstrate its creditworthiness to the Fund and to foreign creditors. The crux of the economic problem of countries of Unbalanced Productive Structures, especially Argentina, is to be found in the country itself. The solution of the problem depends in the last analysis on the ability of its governing circles to correctly grasp the nature of its problems and to carry out economic policies appropriate to the structure of an economy that is in fundamental aspects distinct from the industrailized countries and operating under conditions of a world economy vastly different from that in which these countries embarked on their own development.

# POLITICAL FACTORS

## ECONOMIC AND POLITICAL DEVELOPMENT IN SOUTH AMERICA: THE NEW STYLE MILITARY REGIMES, 1964-85

By Albert Mayio

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## SUMMARY

In 1986, Argentina, Brazil, Peru, Uruguay and Chile increased their national output substantially enough to suggest that they were finally on the road to recovery from the depression that began in 1981-82.

For the first four countries, now under democratic leadership after many years of military dictatorship, the spurt in growth may have come just in time. The democratic consensus in these countries that had developed as a result of the disillusioning experience with the military regimes of the 1964-85 period was in danger of eroding because of the slowness of economic recovery and the persistence of high inflation. By the same token, the large increase in national output in Chile in 1986 may have temporarily strengthened the Pinochet dictatorship.

In all five countries, the armed forces have been greatly discredited both by their failure to prove themselves superior managers of the economy and by their unprecedented repressiveness. As a result, civilian political leaders—except in Chile where fear of the extreme left militates against a united front opposing the regime—

are likely to work harder than ever before to compromise their differences rather than turn again, as so often in the past, to the armed forces to break a deadlock or gain an advantage they could not obtain by the electoral process. They cannot, however, count indefinitely only on popular dislike of the military to assure civilian control. If they are to construct a large and lasting consensus in favor of democracy as the only legitimate form of government, they have to prove they can bring about sustained growth and a more equitable distribution of the fruits of growth.

To succeed, they will need to increase their countries' industrial export capacity and step up their efforts to bring about truly modern market economies. If they can do this, they can attract capital, both domestic and foreign, back to their countries. It seems increasingly clear, however, that they cannot now and perhaps for quite some time generate enough export earnings to enable them both to maintain their current interest payments on their external debt and steadily increase the imports needed for growth.

Peru in 1986 and Brazil in 1987 have opted unilaterally to curtail interest payments in order to achieve growth. Unless world demand soon rises substantially for the primary products that are South America's main exports, or the flow of new foreign credits greatly increases in the next year or two—both uncertain prospects—other South American countries may go the same way as Peru and Brazil. Debt relief negotiated between lenders and debtors permitting the debtor countries to scale down their interest load for a period of, say, two to three years, so they can import what they need for growth would seem to be better than unilateral suspension of interest payments and the enormous problems this gives rise to.

## PART I. THE BACKGROUND

### THE NEW STYLE MILITARY REGIMES

In the 1960's and 1970's, the armed forces of Brazil, Argentina, Peru, Uruguay, and Chile overthrew popularly-elected governments and took direct charge of the political and economic affairs of their respective countries.

Three aspects of these coups stand out:

(1) The military establishments of two of the countries, Uruguay and Chile, broke with a tradition of non-interference in political affairs that went back to the late 19th century and that had only been interrupted once before, in Chile in 1924–27;

(2) Four of the five countries (Peru was the exception) were the most developed countries of Latin America at the time; [1]

(3) The military regimes that were established as a result of the coups were markedly different from previous South American military governments. First, they assumed direct and exclusive control over their nations' political and economic af-

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[1] In the 1960's, Brazil's per capita national income and quality of life indicators placed it well behind Argentina, Uruguay, Chile and Venezuela. However, Southeast Brazil comprising the country's most industrialized and richest agricultural areas was probably as developed as Argentina and more so than Chile, Uruguay, and Venezuela. With 31 million people, Southeast Brazil equalled the combined populations of Argentina, Chile and Uruguay in 1960.

fairs. Second, they vowed to stay in power as long as necessary to correct the ills that had bred civil unrest and disorder. Third, they governed as an institution—the junta of commanders of the armed forces was the supreme authority, and the head of government whom they chose, served at their will.[2] Fourth, national policy decisions were to be made, in Collier's words, on the basis of technocratic and bureaucratic considerations rather than in response to the "economic and political demands from different sectors of society, expressed through such channels as elections, legislatures, political parties, and labor unions." [3]

### WHY THESE COUNTRIES?

The question of why this kind of military regime should have been established in these particular countries bears examination. Four of these countries, Argentina, Uruguay, Chile, and Brazil (or at least Southeast Brazil) were the most developed Latin American countries. The fifth, Peru, while relatively underdeveloped by the standards of the other four, was precocious politically. Untypically for a country at its stage of economic development, Peru had both a professionalized military establishment and a mass, multi-class political party with a more or less coherent ideology.

In the first four countries, economic development had reached a stage marked by two salient characteristics. The first was that economic development and its accompanying processes of universal education, urbanization and politicization had advanced far enough to create politically conscious middle and urban working classes that greatly outnumbered the traditional ruling elites. Second, economic development had generated within each of these classes a variety of conflicting interest groups.

In Peru, the middle clases and the urban labor force were small compared to their counterparts in the other four countries. However, their support of Haya de la Torre's American Popular Revolutionary Alliance (APRA) made it the dominant electoral force in Peru even though it had been kept from operating legally for most of its existence since it had been founded in the late 1920's.

### THE POLITICAL DEADLOCK

The new contenders, the middle and working classes, demanded a share of the power normally monopolized by the traditional elites. The new contenders' demands were driven by the perception that the system, in Anderson's words, was "allocating too large a share of social rewards . . . to the older contenders, the landowners, the military, and the like." [4]

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[2] The Chilean military regime may be an exception to the rule since General Pinochet appears to be more like the classical "strong man" of Latin American tradition—that is, he seems to be more powerful than the junta of commanders of the various services.

[3] Collier, David, editor, "The New Authoritarianism in Latin America," Princeton University Press, Princeton, 1979, p. 4. Collier notes that the new authoritarianism has come to be called "bueaucratic authoritarian." For convenience, the five countries where the new style military regimes were established will henceforth be referred to in this paper as the "BA" countries, even when the referene is to the country before the new style regime was in power or after it ended. Currently, only Chile remains under BA rule.

[4] Anderson, Charles W., "Politics and Economic Change in Latin America: The Governing of Restless Nations," Van Nostrand Reinhold, New York, 1967, p. 107.

At the same time the parties representing middle class and labor interests were continually wracked by inter-party rivalry and internal conflicts. Consequently, even though on a combined basis these parties generally outpolled the avowedly conservative parties by a wide margin in free elections in the post-World War II era, the winning party seldom managed more than a narrow plurality.

In office, it generally found itself hamstrung not only by the opposition, which, regardless of differences in ideology and programs, tended to combine against the government, but also by its own internal splits. As a consequence, no party or faction within a party in control of the government could command enough power or popular support long enough to carry out any coherent policy for economic growth and greater social equity.

By the late 1950's and 1960's, the armed forces in the various countries had come to believe that only they could end the dangerous political immobilism. They feared that a continuation of the political stalemate would lead to ever-increasing violence. And in this eventuality they saw the possible triumph of revolutionary forces—Marxist-oriented in Brazil, Chile, Uruguay and Peru: Peronist in Argentina.

The military had some specific grounds for their fears.

In Brazil, the specific threat was the growing cooperation between the populist forces led by President Goulart and the extreme left. In Argentina, the threat was the return to power of Peron if free elections were reinstituted, and with his return, the resurgence of confrontation politics, and the possibility of civil war.

In Peru, the military perceived the threat as latent subversion growing in strength because of the inability of the political parties to enact needed, drastic social reforms.

In Chile, the military's perception of the threat was that the Allende government would use the power of government and workers militias to establish a Marxist dictatorship.

In Uruguay, the security threat was seen to be a resurgence of the terrorist left if key democratic institutions such as parliamentary government, a free press, the independent judiciary and the educational system which the military perceived as inept and corrupt were not brought under their control.

## THE INTERNATIONAL CONTEXT

The various threats were all the more menacing because they were occurring in the international context of East-West confrontation. Any illusions Latin Americans may have entertained about the irrelevance of the Cold War to them were rudely shattered by Castro's victory over the numerically superior Cuban armed forces. The emergence of Castroite guerrilla groups in many countries of Latin America, including Uruguay, Peru and Argentina brought the point home even more forcefully. Moreover, the unity of the armed forces in Argentina, Brazil and Chile was being directly threatened by the efforts of civilian politicians to win adherents among the officers and enlisted men.

Still another factor in the decision of the armed forces to take over their governments on a long-term basis was what they regarded as the failure of civilian governments to carry out policies that would realize the full potential of their respective economies.

Except for the shock of Cuba and the rise of the Castroite guerrilla movements, none of the foregoing factors was new. The Cold War had been going on since 1945. Attempts of civilian politicians to weaken the military's unity went back to the 19th century. So did guerrilla groups of one kind or another. Dissatisfaction with slow economic progress went back to the 1930s. Nevertheless, these reasons had not previously served to induce the military to establish long-term direct control over the economic and political affairs of their countries. Instead, since the end of World War II, the South American military had followed the "moderating" or "referee" pattern. That is, when they believed public opinion was mounting against an incumbent government—whether civilian or military—the armed forces would intervene to remove the ostensible source of the problem—a Peron, Vargas, a Frondizi, a political party (APRA)—and then schedule new elections so that the public could choose a new team.

## PROFESSIONALIZATION AND THE NEW SECURITY DOCTRINE

The other new factor that persuaded the military that they should abandon the moderating role in favor of taking long-term control of their countries was the development of confidence in their ability to run their country's economic and political life. This confidence was the result of the increased emphasis on professionalization and study in the military "think tanks" that were founded after World War II. These agencies branched out from a purely military curriculum to studies concerned with the political and economic problems of their respective countries. The Brazilian Superior War School (ESG) and the Peruvian Center for Advanced Military Studies (CAEM) have received the most attention among foreign scholars but all the "bureaucratic-authoritarian" (BA) countries had similar institutions.

Because guerrilla warfare had come to be considered as important a threat to internal security as the threat of external aggression, these national war colleges studied all aspects of guerrilla warfare including the economic and social sources of political alienation. Out of these studies emerged a doctrine that sustained economic development was as important as the use of force to eliminate subversion.

The Peruvian military's thinking on how steady economic development was to be achieved differed sharply from that of the armed forces in the other BA countries. They were even more emphatic than the latter about the necessity of economic development as a strategy for ensuring national security. While the overcoming of "latent subversion" by economic development was the main rationale voiced by military spokesmen for the populist policies of the Velasco period, the Peruvian military's huge spending on costly modern weapons suggests an additional and perhaps more important rationale. This was to make Peru a military power formidable enough to its neighbors, Chile, Ecuador, and Colombia, to discourage any designs they might have on Peruvian territory. According to Cotler, the Peruvian military government was "guided by a new 'hypothesis of war'—but Peruvian society was kept ignorant of this assessment." [5]

## THE ECONOMIC CONTEXT

An additional important factor in the decision of the military to take over their governments was the pervasive attitude among the armed forces that popularly-elected governments were incapable of taking the hard measures necessary to enable their economies to realize their full potential.

Table 1 highlights the mediocre performance of the five countries from 1950 to the military coups of the 1960's and 1970's. For instance, in Uruguay, per capita real incomes in 1973 were virtually the same as in 1950. In Argentina up to 1966, per capita incomes had grown at a rate of only 1.2 percent annually, and this growth had been very erratic. Chile in 1973 had averaged an annual rate of growth of 1.9 percent, but this average also masked sharp year-to-year fluctuations.

Brazil and Peru did much better than their neighbors, but even in these two countries, the armed forces were convinced that their economies were not performing as well as they could and should. Moreover, in these two countries and in Uruguay, inflation had increased, and growth rates had fallen in the three years immediately preceding the coups. In Argentina, economic recovery in 1964, and 1965 was beginning to fade in the first half of 1966, and inflation was increasing. In Chile, the growth rate was marginally higher than the 1950–73 trend rate but by late 1972 the economy began to deteriorate rapidly as a result of the increasing number of confrontations between the Allende government and the opposition.

TABLE 1.—SELECTED SOUTH AMERICAN MILITARY REGIMES: REAL PER CAPITA GDP AND INFLATION RATES, 1950–1976

| Countries | Date of coup | Average annual growth rates (percent) | | | | | |
|---|---|---|---|---|---|---|---|
| | | Pre-coup period (1950 to coup year) [1] | | Years preceding coup year [1] | | Year before coup year [1] | |
| | | Per capita GDP | Prices | Per capita GDP | Prices | Per capita GDP | Prices: Percent change from previous year |
| Argentina I | June 1966 | 1.2 | 28.1 | 4.5 | 23.5 | 7.7 | 25.9 |
| Argentina II | March 1976 | 1.9 | 26.9 | 1.0 | 51.6 | −2.0 | 182.5 |
| Brazil | March 1964 | 3.5 | [2] 38.0 | .9 | 50.7 | −1.0 | 71.0 |
| Chile | September 1973 | 1.9 | [3] 29.0 | 2.0 | 39.4 | −2.7 | 79.1 |
| Peru | October 1968 | 2.8 | 7.8 | 2.2 | 11.4 | .8 | 10.0 |
| Uruguay | June 1973 | .2 | 32.1 | −1.2 | 35.4 | −2.0 | 76.5 |

[1] Full calendar year preceding coup

[2] 1957-63 IFS data begin in 1957.

[3] 1963-72 IFS data begin in 1963.

Sources: Per capita GDP data, 1950-69, Economic Commission for Latin America, United Nations, "Series Historicas del Crecimiento Economico y Social de America Latina, Santiago, Chile, 1977; GDP data, 1960–84, Inter-American Development Bank, Price data are from "International Financial Statistics: Yearbook 1980," International Monetary Fund, Washington, D.C. Growth rates calculated by author.

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[5] Cotler, Julio, "Democracy and National Integration in Peru," in McClintock and Lowenthal, Abraham F., editors *The Peruvian Experiment Reconsidered,* Princeton University Press, Princeton, N.J., 1983, p. 28. Cotler ascribes purely defensive reasons for the Peruvian regime's "hypothesis of war." But the Peruvian military may have had another goal in mind, namely the development of enough military strength to force Chile to return the huge territory wrested from Peru in the War of the Pacific of 1879. Cotler states that Peru's defeat in that war "became the nightmare of the Peruvian army."

## PART II. THE MILITARY IN POWER

### THE POLITICAL AGENDA

On assuming power, the immediate political tasks the military regimes imposed on themselves were to restore public order where this has been seriously disrupted as in Brazil, Chile, Uruguay, and Argentina (in 1976), and, in all the countries, to intimidate opponents and potential opponents by arrests, dismissals from the bureaucracy, the military and the universities and secondary schools. Political and labor union activities were suspended, censorship was imposed, and martial law put into effect.

Except for a prolonged dominant role for the armed forces in the "new" state, there seems to have been no initial consensus in any of the military establishments about the kind of political structure that state should ultimately have. The military seem to have been substantially agreed on either doing away with political parties and trade unions or bringing them under the control of the state after purging them of "corrupt" elements and those likely to make trouble for the regimes. In this way, the perceived main sources of their country's ills would be eliminated. Once in power, however, all the regimes except that of Argentina, developed some kind of blueprint for the future.

In Brazil, Chile and Uruguay, the models differed in detail but were similar in essential respects. The central idea was that of an authoritarian republic with a strong executive and an elected legislature with limited powers in which only approved parties would be allowed to participate. All of these plus the judiciary would be subordinate to the armed forces as the supreme residual authority.

Only the Brazilian regime put its plan into effect, and this it did in 1969. In Chile, the first popular elections for the legislature were scheduled for 1990, the first presidential election in 1997. In Uruguay, the plan called for a National Security Council controlled by the armed forces as the supreme authority. The actions of the executive and legislative branches were to be subject to its approval. The congressional elections were to be free, but the presidential elections were to be restricted to one single candidate approved by the military. The military felt so sure that it had popular support that it submitted the proposed constitution to a plebiscite in November, 1980. The voters rejected the constitution by a vote of 58 percent to 42 percent. Stunned by the vote and by a huge scandal in 1981 involving senior officers, the military began talks with political party leaders looking to free general elections in 1984 and the return to constitutional government.[6]

In Peru, the political model that the military had in mind was ambiguous. In the 1968–75 period under General Velasco, the regime seemed to be moving toward a socialist corporate state. The military team that replaced Velasco in 1975 in effect dropped the idea when it phased out many of the institutional changes and innovations of its predecessor.

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[6] Aguilar, Luis E. "Latin America 1985," Skye Corporation, Washington, D.C. 1985, p. 125.

### THE ECONOMIC AGENDA

The highest immediate economic priorities of the bureaucratic-authoritarian regimes were, except in Peru, to check inflation and rebuild foreign exchange reserves. In Peru in the late 1960's and the early 1970's inflation and the lack of foreign exchange were not yet grave problems. The longer-term goal was, again with the exceptions of Peru in 1968–75 and Brazil after 1967, to transform the state-dominated economies into market economies capable of competing better in world markets for manufactured products as well as for primary commodities. In Peru, the longer-term goal of the Velasco regime was state-directed industrialization, a process in which Peru lagged far behind the other countries. In Brazil under Marshal Castello Branco, and in Argentina, Chile and Uruguay, the regime leaders believed they could bring about an efficient free market economy by major reforms: a large reduction in the public sector; a more efficient tax collection system; rigorous fiscal and monetary discipline; a sharp reduction in tariffs and non-tariff barriers; the elimination of burdensome business regulations, and a sharp curtailment of the power of labor unions to raise wages about productivity increases.

These objectives clashed with deeply-rooted corporatist ideas and practices: a strongly centralized state with a powerful economic role, a large government bureaucracy, consumer subsidies for the middle classes as well as for the poor, and subsidies and protection against foreign competition for domestically owned business firms. Consequently, the military regimes were undertaking nothing less than profound social as well as economic revolutions.

At the same time, because military officers themselves were raised in the statist tradition, educated in the closed military school system and heavily involved in managing state enterprises and decentralized public agencies, the rigor with which the revolutions were carried out varied from country to country. To a great extent, this depended upon the personal power and conviction of the senior military leaders. In Argentina, Chile, Uruguay, and in Brazil in 1964–67, senior military officers opted for the "liberal", free market strategy. In Brazil, after March 1967, the statist approach replaced the "liberal" policy.

#### *Brazil: 1964–85*

The Brazilians diverged from classical monetarist and "liberal" policies even in the stabilization phase of April, 1964 to March, 1967. Public investment and credit to the private sector were increased, and wage controls imposed. Prices that had been under controls during previous governments were freed as a means of correcting distortions in relative prices, but were reimposed within a year as price increases showed no signs of abating.

By early 1967, the inflation rate had fallen to 40 percent from the high of 92 percent in 1964, but output continued to stagnate. In March, 1967, General Costa e Silva succeeded Marshall Castello Branco as president. He and his new economic team decided that economic stagnation was too high a price to pay for controlling inflation. Stabilization, accordingly, became subordinate to achieving growth. Also, although lip service continued to be paid to the importance of the private sector, the state became the driving force for development, and the public sector substantially increased its traditionally large role in the Brazilian economy. By increasing public sector investments and thereby stimulating private investment, high growth rates were achieved in the 1968–73 period. Inflationary pressures actually eased, with consumer prices averaging 20 percent annually during the period, low by Brazilian standards. In 1974–78, a period of adjustment to high oil prices and recovery of real wages, inflation stabilized at about 40 percent annually. In 1979 and 1980, however, inflation averaged 100 percent. Austerity measures were imposed in late 1980, and these in conjunction with the subsequent world recession, high world interest rates, and drastic reduction in new financing from abroad caused per capita GDP to fall three years running, 1981–83. This was the longest and severest decline since the Depression of the 1930's. The economy recovered somewhat in 1984, but inflation continued to increase, hitting almost 200 percent in 1984, the last full year of the military regime.

Other main differences with the economic policies of the other military regimes should be noted: (a) almost all contracts as well as wage were indexed to prices; (b) the exchange rate was kept in line with inflation, rather than being kept overvalued as it was in the other three countries; (c) an all-out policy of internal development and export promotion was pursued, employing a variety of incentives, including reductions of internal taxes, outright subsidies, and exemption from or drastic reduction of duties on imported materials, components and capital goods deemed by the government as essential to its development and export goals; and (d) domestic firms remain protected from foreign competition through the government's import licensing system.

### *Argentina: 1966–73*

The Ongania regime floundered around for half a year in search of an economic policy. It finally found in Krieger Vasena, a man who had one. The new minister put into effect an incomes policy that was simple, flexible and effective.

First, selective wage increases were decreed for most workers, with the percentage increase determined so as to put all workers on an equal footing for the ensuing wage freeze. The freeze lasted until the end of 1968. However, employers were free to grant pay increases above official ceilings provided they did not raise prices to cover their increased wage costs. Since productivity increased substantially because of a sharp decline in days lost through absenteeism and strikes, workers in many firms obtained wage increases. These increases, coupled with a reduction in the inflation rate from 23 percent in 1967 to seven percent in 1969 brought about a general increase in real wages of nine percent between 1967 and 1969.[7]

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[7] Maynard, G. and van Rijckeghem, W., "Argentina: A Stabilization Attempt that Failed", in Banca Nazionale del Lavoro Quarterly Review, December, 1972, p. 401.

A second key principle of the stabilization program was increased bank credit to the private sector so that the latter could at least maintain—or preferably, increase—current production levels despite higher operating costs. These costs were higher because of the initial wage increases and some of the anti-inflationary measures. Thus, to reduce the public sector deficit, state-owned public utilities and other enterprises were required to raise their charges to the public to cover costs. Other government subsidies to consumers were also reduced, and the prices of imported products rose as a result of devaluation.

A third feature of the Krieger Vasena policy was the reduction of the central government deficit from 33 percent of total government expenditures in 1966 to about 14 percent in 1969. The results of the program besides those already mentioned were a decline in unemployment, a vast improvement in the balance of payments and in foreign exchange reserves and an average rate of growth of real GDP of 5.5 percent.[8]

Despite the success of his program, Krieger Vasena resigned in mid-1969 when his military superiors made him and his policies the scapegoat for the eruption of labor violence in the industrial city of Cordoba in May, 1969. His immediate successor held to Krieger Vasena's general policy but this policy began to fall apart in late 1969 when prices rose sharply. The rate of growth of per capita GDP fell to nil in 1972, the inflation rate rose to 59 percent, and it was still accelerating when the military withdrew from power in May, 1973.[9]

### *Peru: The Velasco Era: 1968–75*

The main features of the Velasco regime's revolutionary program were: an all-out import substitution policy; a thorough-going land reform; a substantial reduction in the role of foreign corporations in the Peruvian economy; co-participation of labor in the management and profits of industrial companies; and the creation of several organizations to control the political mobilization of social sectors hitherto poorly represented in Peru's political processes: small farmers, landless rural workers, urban workers and the recent migrants from the rural sectors to the cities.

To cover the high cost of these reforms, the regime resorted to large deficit spending and high-cost short-term borrowing abroad. The consequences took some time to materialize. By virtue of strong world markets for its exports and foreign bank loans based in large part on what seemed most promising oil finds, the Peruvian economy did well until about 1973. Per capita GDP rose at an annual average rate of 3.1 percent. Export earnings rose at an annual rate of 7.6 percent, and the rate of inflation was relatively low as compared to other South American countries. However, export earnings were high because of inflated world prices, the actual volume of Peru's exports having declined so that in the 1973–75 period they were about 30 percent below the 1968 level.

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[8] Ibid., p. 396.

[9] Maynard and van Rijkeghem attribute the breakdown of the stabilization policy primarily to the sharp rise in the price of beef in late 1969 and early 1970 that triggered a new round of inflation. Krieger Vasena had been out of office several months when beef prices spurted upward. Maynard and van Rijkeghem fault him, nevertheless, for not having done something to correct the beef cycle problem, the origins of which they ascribe to the chronic neglect of the agricultural sector by Argentine governments since World War II. However, it is difficult to see how Krieger Vasena or any other person could have solved both the stabilization and the agricultural problems in the relatively short time he was in charge of economic affairs.

External shocks were a further source of trouble. Fishmeal exports, which accounted for a fourth of Peru's export earnings in the 1969–72 period, fell $100 million in 1973, 41 percent. World prices for copper, Peru's main export fell 40 percent in 1975. The current account deficit increased four-fold in 1973, rose another 150 percent in 1974 and doubled in 1975. Consumer price increases which had averaged 7.7 percent in 1962–67 rose 11 percent in 1973, 17 percent in 1974 and 24 percent in 1975. Unemployment rose, and real wages fell—15 percent for blue collar workers and almost 23 percent for white collar workers between 1973 and 1975.[10] Popular discontent in February, 1975, led to a doubling of strikes. A police strike in February, 1975, led to wide-spread looting and to the burning of some government offices. McClintock writes: "The events spelled the end of the Velasco government, not so much because some groups had agitated against it, but because thereafter no groups came to defend it." [11]

### *The Morales Regime, 1975–80*

General Velasco was ousted in a military coup in August, 1975, and General Morales took over the country's leadership. He let die most of the reforms of the Velasco period. While he left land reform intact, he did not push it further. His regime had its hands full coping with the enormous economic problems it had inherited. Unwilling to accept the austerity measures required by the IMF, the regime negotiated new loans from foreign banks in March 1976 conditioned on reducing the government deficit. By the first quarter of 1977, however, the banks refused any more assistance because of the failure of the government to carry out the agreed program. With its foreign exchange reserves dwindling and huge debt repayments to be made, the government resumed negotiations with the IMF in March, 1977. These dragged on until November when the regime finally agreed to the Fund's strict austerity measures. Meeting the worst protests it had ever faced, the regime failed to carry through the program, and the IMF suspended assistance in February, 1978. In May, 1978, near what Cline terms "external bankruptcy", the regime undertook a drastic austerity program of its own designed to win IMF approval and help. This was forthcoming in July, 1978.

The various stabilization attempts, including the 1978 IMF standby, failed to halt inflation—the rate of increase of consumer prices rose from 34 percent in 1976 to 67 prcent in 1979. However, the regime, generally helped in the 1978 and 1979 by rising prices for its exports, was very successful in dealing with the balance of payments crisis. The current account deficit was converted by stages from $1.6 billion in 1975 into a surplus of $1.7 billion in 1979.

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[10] Cline, William R., "Economic Stabilization in Peru," in Cline, William R. and Weintraub, Sidney, editors, Economic Stabilization in Developing Countries, The Brookings Institution, Washington, D.C., 1981, p. 318.

[11] McClintock, Cynthia, "Velasco, Officers and Citizens," in McClintock and Lowenthal, editors, op. cit., p. 300.

The cost of this achievement was high. The economy remained depressed throughout the period. Whatever popular support the regime had enjoyed initially steadily deteriorated. Public protests over the austerity programs and repressive measures to contain them descredited the military, and exacerbated tensions within their ranks. Public opposition to the regime was such that the military believed they had no choice but to carry out the scheduled transition to civilian rule. By May, 1980 they were only too eager to hand over Peru's problems to a civilian government.

### *Uruguay, 1973–85*

It took the Uruguayan military 18 months to make up their minds as between a nationalist economic policy and a policy geared to integrating the economy more closely into the world trading and financial system.

The internationalists won, and a monetarist economics minister, Vegh Villegas, took charge in September 1974. In July 1976, under unremitting attack by nationalist and populist officers for his policies, he resigned. However, his economic team remained intact, and his former deputy who succeeded him as minister stuck to the main lines of the program Vegh Villegas had inaugurated.

The cornerstone of this program was the reduction of the money supply while at the same time increasing credit to the private sector. The public sector deficit, accordingly, was to be cut, and more and more of it was to be financed by tapping private savings rather than using central bank credit. By 1978, the money supply in real terms had been cut 16 percent below the 1973 level despite a 21 percent increase in total GDP. Credit to the private sector had increased by 62 percent.[12] The central government's deficit rose from $27 million to $30 million at the exchange rates prevailing in the 1973–78 period. In 1979, however, the central government's finances in real terms were virtually in balance, and in 1980 a surplus of $2.2 million was realized. After 1980, the deficit rose sharply.[13]

On taking charge, Vegh Villegas abolished exchange and import controls of twenty years standing. He also abolished a large number of low-yielding taxes and the largely evaded personal income tax, replacing them with a value added tax and a 30 percent tax on business profits.[14]

Prices as well as wages were frozen, but prices were soon decontrolled in stages while wages remained controlled throughout the regime's tenure. Tariffs were also reduced in phases. However, the main instrument for encouraging import competition to make Urugayan industrial concerns more efficient was overvaluation of the exchange rate.

This policy undoubtedly kept Uruguay's exporters of meat and hides and other agricultural products from maximizing their export earnings, but they may have been compensated for this by the growth of non-traditional exports, 95 percent of which were of agricultural origin. Because of tax credits and other incentives, non-traditional exports rose from 25 percent of total exports to 64 percent in 1978. They dropped back to 48 percent in 1980 and 1981 and probably fell even further thereafter because of the world recession and protectionist measures against textiles and leather goods in the United States and Europe.[15]

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[12] Gonzalez, Louis E. and Notaro, Jorge, "Alcances de Una Politica Heterodoxa: Uruguay, 1974-78," Working Papers, Latin American Program, The Wilson Center, Smithsonian Institution, Washington, D.C., p. 19.

[13] International Monetary Fund. "International Financial Statistics Yearbook 1980," (IFS) and IFS, October, 1980. Conversions in U.S. dollars are by the author.

[14] Diaz, Ramon, "Uruguay's Erratic Growth," in Harberger, Arnold C., World Economic Growth, Institute for Contemporary Studies, San Francisco, Cal., 1982, pp. 395-396.

The civilian economic ministers also tried to sell off the state enterprises to the private sector, but here they made no headway against the combined opposition of the bureaucracy and its sympathizers in the military establishment.[16]

In short, the Uruguayan economy prospered under the military regime until the various external shocks of the early 1980s pushed it, like its sister economies, into the worst slump since the 1930s. If, however, official Uruguayan real wage and unemployment data for the 1973–1980 period accurately portray what was happening to white and blue collar workers, social tensions undoubtedly increased even during the prosperity period. These data show real wages for both groups of workers declining steadily throughout the period to 1980 when they were 34 percent below the 1973 levels and 47 percent below the 1971 levels.[17]

Unemployment remained high and well above the 1970–72 level of 7.6 percent except in 1979–81. In 1976, unemployment rose to 12.6 percent and remained near that rate until 1979. It fell to the regime's low point of 6.5 percent in 1981 only to reach another peak, 16 percent, in 1983. In 1984, the last full year of the military regime, it was 13.3 percent. In 1982, per capita GDP dropped 11 percent and continued to slip thereafter. In 1984, it was 18 percent below the 1981 level.[18]

### *Chile, 1973–*

The Chilean regime carried out the strictest monetarist policy of all the BA countries. It imposed wage controls but removed all price controls. It raised the prices of public services, cut government expenditures sharply, and severely restricted credit to the private sector. Heedless of the recession and rising unemployment caused by a year of severe contractionary policies, the regime then applied "shock treatment," tightening the economic screws even further. By 1975, per capita GDP had fallen 14.3 percent from the depressed levels of 1972–74. In 1976, unemployment which had been four percent in 1970 rose to 19.8 percent. It then fell gradually until it hit a regime low of 13.4 percent in 1981. But in 1982, it virtually doubled. Thereafter it declined and in 1985 stood at about 15 percent.[19]

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[15] Weinstein, Martin, "Uruguay: Military Rule and Economic Failure," in Wesson, Robert, editor, Politics, Policies, and Economic Development in Latin America, Hoover Institution Press, Stanford University, Stanford, Cal., 1984, p. 41.

[16] Ibid., p. 40.

[17] Ibid., p. 42.

[18] Bureau of Inter-American Affairs, Department of State, "Economic Data Chart: Uruguay", Washington, D.C., November 11, 1985.

[19] Data for 1976–80, French-Davis, Ricardo, "The Monetarist Experiment in Chile," World Development, November, 1983, p. 918: for 1980–85, Inter-American Development Bank, data sheet for unemployment graph, Economic and Social Progress in Latin America: 1986 Report, Washington, D.C., 1986, p. 227.

The regime slashed tariffs, streamlined the public sector and improved the taxation and social security systems. The combination of low tariffs and an overvalued exchange rate, however, encourages an unprecedented flood of imports, much of which were consumer durables and luxury goods. The impact on many domestic businesses and on the banks which financed them was devastating.[20] In 1976, though, the economy registered positive growth rate, 1.9 percent in per capita incomes. In 1977–81, it averaged a six percent per capita GDP growth rate, offsetting the average annual rate of decline during the 1973–76 period of 5.7 percent. In 1982, the combination of external shocks, of which the sharp drop in copper prices may have been the most important, and the overvaluation of the exchange rate brought about a decline of 16 percent in capita GDP and an unemployment rate of 27 percent.[21] Per capita GDP declined further in 1983, improved somewhat in 1984 and remained at that level in 1985. This was 13.6 percent below the 1981 level and 6.3 percent below the 1970–72 average.

### *Argentina: 1976–83*

The Videla regime carried out a gradualist anti-inflationary and trade liberalization strategy. Much like its civilian predecessors, however, the regime was forced to shift the emphasis of its policies several times. Initially it freed prices from all controls and subsidies; then it resorted to price freezes; it froze wages for a time and then indexed them. Like Chile and Uruguay, it lagged devaluations behind the rate of inflation in order to encourage imports. The brief war with the United Kingdom over the Falkland islands was a heavy drain on the treasury, and on the balance of payments. As a result, import licensing was re-instituted and imports severely restricted after several years of encouraging imports in line with free trade principles.

Although economic minister Martinez de Hoz was a firm believer in divesting the government of its many enterprises, he could not overcome opposition from within the military, many of whose active duty and retired officers occupied key positions in these firms.[22]

Argentina's economic performance under the military regime of 1976–83 was the worst of the five countries under bureaucratic-authoritarian rule. In terms of growth, the best years were 1977, 1979 and 1980 when per capita GDP approximated the pre-military year of 1974. In 1981 per capita GDP dropped eight percent and in 1982, 6.8 percent. In 1983, the last year of the regime, per capita GDP rose 1.6 percent over 1982 but was still 17 percent below the 1980 level.

The regime cut the annual rate of increase of consumer prices from 443 percent in 1976 to around 100 percent in 1980, but thereafter prices rose sharply. In 1983, the rate of inflation was 344 percent and still accelerating.

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[20] Sigmund, Paul E., "The Rise and Fall of the Chicago Boys," SAIS Review, Summer-Fall, 1983, Vol. 3, No. 2, p. 48.

[21] The unemployment rate includes 22 percent open unemployment and 5 percent unemployment absorbed by government works projects. French-Davis, Richaro, "The Monetarist Experiment in Chile: A Critical Survey," World Development, Vol. 11, No. 11, November, 1983, p. 918.

[22] Wynia, Gary W., "Argentina: The Frustration of Ungovernability," in Wesson, editor, op. cit. pp. 31-2.

## PART III. EVALUATING THE PERFORMANCE OF THE MILITARY REGIMES

### INTRODUCTION

Civilian rule was restored in Peru in 1980; in Argentina in December, 1983; and in Brazil and Uruguay in 1985.

The military in these countries were not forced out of office by insurrection, paralyzing strikes or massive civil disobedience. They withdrew from power voluntarily, even defiantly, and according to their own timetable. In the end, though, the military withdrew because the popular support that was once theirs had vanished. In short, the point had been reached where continuation in office would sooner or later have required harsher and more far-reaching repressive measures. Whether or not this would have provoked massive popular resistance or even insurrection, the military opted to withdraw from power.

It is too soon since the military left office to predict what the lasting effects of their rule will be. It is not too soon, however, for an assessment of their performance in office based on presently available evidence. Such an assessment should be made in terms of the objectives the military set for themselves when they overthrew the constitutional governments of their countries and installed themselves in power.

These were: (1) to eliminate the threat of large-scale internal, armed conflict which was perceived by the military in Chile, Brazil and Argentina (in 1976) as an imminent danger and in Peru and Uruguay a near-term possibility; (2) to assure internal peace and stability over the long-term by destroying the hold of populist and leftist leaders and parties over the people; and (3) to create the conditions for sustained economic growth. The last objective was seen not only as a good in itself but also as a means of achieving the second objective. Sustained growth, the military believed, in itself would enhance the quality of life of the people and turn them away from both populist and revolutionary movements. Additionally, sustained growth would enhance the bargaining power and prestige of their countries in regional and international affairs.

### ELIMINATING THE SECURITY THREAT

Left-wing guerrilla groups have not re-emerged, at least in any force, in Argentina, Brazil and Uruguay. In Peru, a Maoist guerrilla movement, which developed while the military were in power but did not make its presence really felt until 1980, is now a formidable force. It is apparently still gaining strength despite the military's long campaign against it. In addition, the Communists are now the second largest political party in Peru. In Chile, armed assaults against the Pinochet regime are on the rise, but these may work to the regime's advantage as they revivify the people's fear that a return to democracy will usher in another era of political and economic chaos and a renewed threat of civil war. At the same time, the very repressiveness of the regime tends to erode the resistance of the democratic opposition to cooperation with the extreme left, thereby enhancing the chances of large-scale civil strife in the future.

In Argentina, sporadic terrorist assaults have occurred against government leaders, including President Alfonsin himself. These seem to be the work of individuals rather of any organized movement, though the "war crimes" issue—what is to be done about the hundreds and perhaps thousands of people who were involved in one way or another with the deaths and torture of their fellow citizens under the military regime—remains a threat to the present moderateness of Argentine political life.

## DE-RADICALIZING SOCIETY

How successful have the military regimes been in reducing the appeal of the populist and leftist parties?

In Argentina, Uruguay, and Peru, the traditional populist parties again dominate politics in their respective countries. In Argentina, the Radicals have replaced the Peronists as the leading party in elections, but the Peronists still have very large support. On a combined basis, the two parties greatly outpoll the conservative parties. In Uruguay, the historically dominant Colorado party continues to attract the largest support. In Peru, the populist APRA, long the anathema of the military, won the national elections of 1985. In Chile, since political parties are banned, there is no way of judging the popular support the extreme left would command if free elections were held.

In Brazil, all the parties of the 1946–64 era were dissolved by the military regime in 1965. Three new parties created under the military regime seem to be evolving into a triad somewhat resembling the three parties that dominated Brazilian politics in the pre-coup era.

However, in Brazil's patrimonial society, according to Roett, real power resides in the small elites drawn from the planter oligarchy, the bureaucracy, the military, the financial and business groups, and the export-oriented and commercial interests. While there are often conflicts over policy within this group, they are bound together by the common interest of keeping real political power in their hands and by congruent political views and attitudes. Hence, disputes within the elite tend to be settled peacefully by compromise and accommodation.[23] President Goulart challenged the system in 1962–64 when he tried to mobilize mass support to increase his power within the establishment to introduce real structural changes. He was ousted for doing so. As Roett writes, "The sharing of power is acceptable: the hogging of power is not." [24]

The elites encouraged the military coup of 1964 and continued strongly to support the military regime well into the 1970's. When, however, it began to look more and more as though the "palace guard" and their "technocratic" associates were intent on holding power exclusively and indefinitely, the elites turned against the regime. McDonough's comment puts the situation in a nutshell:

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[23] Roett, Riordan, "Brazil: Politics in a Patrimonial Society," Third Edition, Praeger Publishers, New York, 1984, pp. 17–22.

[24] Ibid., p. 30.

. . . "the regime itself had turned sour: the rules of elite conduct had been persistently violated." [25]

As of late 1986, none of the overt political forces in Brazil seemed intent on mobilizing the masses or social groups not already represented within the elite. To a large extent, the shadow of the military is enough to discourage such tactics. But the present moderateness of Brazilian politics also reflects the renewed unity of the elite. Is that enough to assure internal political stability?

Large sectors of the population are still virtually excluded from national policymaking. These excluded groups—small farmers and landless workers, urban labor, and the wage and salary-earning middle class—accepted or were resigned to elite rule when Brazil was still largely a disjointed, rural society. Then urban labor and the middle classes were small in number, and the rural poor were politically apathetic.

Brazil today is a far cry from what it was two decades ago or even a decade ago. In 1960, 52 percent of the labor force was still engaged in agriculture; in 1980 only 30 percent was. In 1960, 45 percent of the population lived in urban areas: in 1982, 69 percent did. In 1960, 35 percent of the urban population lived in cities of 500,000 or more, in 1980, 52 percent did.[26] In 1960, 61 percent of the population was literate; in 1980, 76 percent was.[27]

Urban labor and the middle classes are now much larger than they were in the 1960's. Along with the rural poor, they are also probably much more politically conscious than they were in the 1960's because of increased urbanization, industrialization and literacy.

The patrimonial tradition in Brazil is deeply rooted, and, in the view of many experts on Brazil, still very strong. It will have to be very strong, indeed, to keep growing numbers of Brazilians content with elitist rule.

## BRINGING ABOUT SUSTAINED GROWTH

Despite their ideological and programmatic differences, all five military regimes shared the goal of bringing about rapid and sound economic growth.

Table 2 shows how far short of their goals they ended up. If we attach as much importance to controlling inflation as we do to growth, none of the regimes did well on both counts. Argentina under the regime of 1966–73 surpassed its growth rate of the 1950–65 period, but its inflation rate remained high. Moreover, in the last few years before the military regime left office, growth had virtually ceased, and inflation had doubled.

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[25] McDonough, Peter, "Power and Ideology in Brazil," Princeton, N.J., 1981, p. 231, quoted by Roett, op. cit., p. 20.

[26] World Bank, "World Development Report," 1984, op. cit., tables 21.2.

[27] Morris, Morris David, "Measuring the Condition of the World's Poor: The Physical Quality of Life Index," Overseas Development Council (ODC) Washington, D.C., 1979, p. 156 (for 1960 value) and ODC, "United States Foreign Policy and the Third World: Agenda 1985-6," p. 220 (for 1980 value).

TABLE 2.—SOUTH AMERICA: NEW STYLE MILITARY REGIMES AND ESTABLISHED DEMOCRACIES: REAL PER CAPITA GDP AND INFLATION, 1950–84

[Average annual growth rates, percent]

| Countries | Coup date | Precoup period: 1950 to coup year [a] |  | Military rule period |  | Last full year of military rule |  | Civilian rule restored |
|---|---|---|---|---|---|---|---|---|
|  |  | Real per capita GDP | Prices | Real per capita GDP | Prices | Real per capita GDP | Prices percent change over previous year |  |
| Military regimes |  |  |  |  |  |  |  |  |
| Argentina I | 6/1966 | 1.2 | 28.1 | 3.0 | 27.0 | 0.3 | 58.9 | 5/73 |
| Argentina II | 3/1976 | 1.9 | 26.9 | 2.7 | 187.0 | 3 | [b] 626.7 | 12/83 |
| Brazil | 3/1964 | 3.5 | [c] 38.0 | 4.8 | 49.8 | 2.1 | 196.7 | 3/85 |
| Chile | 9/1973 | 1.9 | [d] 29.0 | [e] 0.8 | 57.1 | 4.2 | 19.8 | ([f]) |
| Peru | 10/1968 | 2.8 | 7.8 | 1.2 | 24.9 | 1.7 | 66.6 | 5/80 |
| Uruguay | 6/1973 | 2 | 32.1 | 1.0 | 51.3 | −2.8 | 55.3 | 3/85 |
| Established democracies |  |  | 1950–69 |  | 1970–84 |  | 1984 |  |
| Colombia | ([g]) | [g] 2.7 | [g] 12.1 | 2.4 | 22.8 | 0.9 | 27.0 | ([f]) |
| Costa Rica | ([g]) | 2.9 | 1.9 | 1.2 | 16.3 | 3.0 | 12.5 | ([f]) |
| Dominican Republic | ([g]) | [h] 3.2 | [h] .5 | 2.7 | 10.4 | −.9 | 27.0 | ([f]) |
| Mexico | ([g]) | 3.1 | 4.7 | 2.6 | 25.0 | .5 | 65.0 | ([f]) |
| Venezuela | ([g]) | [g] 2.3 | [g] 1.0 | .03 | 9.8 | −4.4 | 12.2 | ([f]) |

[a] Full calendar year preceding coup year.

[b] Though civilian government installed December 10, 1983, 1983 = taken as last full year of military rule.

[c] 1957–63.

[d] 1963–77.

[e] 1973–86.

[f] Still in power.

[g] Not applicable.

[h] 1959–69; civilian government established in 1958.

[i] 1967–69; civilian government installed in 1966.

Sources: UN Economic Commission for Latin America, "Series Historicas del Crecimiento de America Latina," Cuadernos Estadisticos de la CEPAL, Santiago, Chile, 1978; 1960–84 GDP data from Inter-American Development Bank, Washington, D.C.; price data from IMF, International Financial Statistics.

Brazil's growth performance was the best of the Latin American countries during the 1964–84 period and surpassed the trend rate. However, inflation worsened. Like the Argentina regime, the Brazilian military government bequeathed its civilian successor an accelerating inflation to cope with.

Under its military regime Uruguay slightly improved its growth rate. However, inflation rose from 32 percent to 51 percent in the 1973–85 period and was still growing when the government was returned to civilian hands.

Argentina under the military regime of 1976–83 was the only country to show in absolute decline in per capita GDP, the rate of decline averaging 2.7 percent annually. To make matters worse, the inflation rate rose six times what it had been, and was increasing exponentially when the military left office.

Chile and Peru also experienced substantially lower growth and much higher inflation under military rule than they had experienced in their respective pre-coup periods. However, during the 1980–86 period, a time of very high inflation throughout South America, Chile's average annual rate of inflation was only 21.1 percent.

### THE PUBLIC SECTOR

The three military regimes that set as their goal the restructuring of their economies along free market lines failed in the attempt, although the Chilean regime may yet succeed in doing so if it is able to stay in power long enough. Argentina and Uruguay were unable to shrink their respective public sectors or to eliminate their deficits, a major source of inflation. In the two countries—and Brazil until March, 1967—even though the military leadership was in favor of reducing the economic role of the state, the opposition from within military ranks was such that the public sector and its operations were left intact.

In Peru, the military regime from the first assigned the key role in development to the public sector. It did, however, attempt to stimulate the development of an indigenous, strong private sector. Through import substitution policies it did build up a new entrepeneurial base, but its other reform policies enhancing the role of labor and the state discouraged private investment, domestic and foreign, led to huge capital flight and greatly increased the country's balance of payments problems.

Until 1980, the Chilean regime had made much progress in reducing the role of the state in the economy. By 1978 it had sold off or returned to former owners 433 of the 464 firms belonging in whole or in part to the public sector.[28] It eliminated the public sector deficits, reduced the operations of publicly-owned banks, and privatized the social security system. Probably because of military opposition, however, the regime did not sell the giant state-owned copper mining complex and other state-owned firms involved in the development of the country's natural resources.

The movement toward a free market economy received a severe setback in 1980. To avert a panic which threatened the whole financial system and Chile's international creditworthiness, the government took over a number of major financial institutions and the firms they controlled. Ironically, a major reason for the failure of the financial institutions seems to have been the result of the government's policy of stimulating import competition. Domestic firms, squeezed between tight credit, high interest rates and industries were not able to compete with imports, became delinquent in their debt to the banks, thereby bringing the banks to the edge of ruin. As a result the government ended up controlling 85 percent of the total bank credit.[29] As of 1982, it also controlled 71 percent of the net worth of Chile's 100 largest nonfinancial enterprises.[30]

In 1985 and 1986, the Pinochet regime sold off some of the firms and financial institutions acquired in 1980 and afterwards.[31] It seems intent once again on reducing the public sector, but in the meantime it has left the private sector's domestically-owned industries and firms in a weakened condition as a result of its policies.

In Brazil, the reduction of the public sector was the goal primarily of the civilian technocrats in charge of economic policy in the

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[28] Brazil and Chile," World Development," November, 1980, p. 905.

[29] Sigmund, Paul E., "Chile: Free Market Authoritarianism," in Wesson, op. cit., p. 10.

[30] Milius, Byron, "The Economy", in Merrill, Andrea T., editor, Chile: A Country Study, Foreign Area Studies, the American University, Washington, DC, 1982, p. 130.

[31] The Washington Post, May 23, 1986.

1964-66 period. Their successors, in contrast, thought they could achieve more rapid and sustained growth by increasing public investment. Like them, the Peruvian military in the 1968-75 period were, as stated previously, convinced that only the government could make the large investments necessary for rapid industrialization and that only import substitution policies and rigid control over foreign investments could reduce Peru's dependence on foreign capital.

The record of the regimes in reducing public sector deficits was mixed. Chile was the star performer, generating surpluses in four of the five years in the 1978-82 period.[32]

Peru also did well, reducing its public sector deficit to 1.7 percent of GDP in 1982 from 6.3 percent in 1978. By contrast, Argentina and Brazil doubled their public sector deficits during the same period to 14.2 and 13.8 percent, respectively.

### DISMANTLING THE PROTECTIONIST STRUCTURE

Only Chile drastically reduced import duties and eliminated virtually all non-tariff trade barriers. Import duties averaged 10 percent in the 1979-82 period as compared to the 94 percent level of the pre-coup era. In 1983, import duties were doubled. These were still by far the lowest of the five BA regimes. The Brazilian regime reduced tariff rates by almost half between 1966 and 1969. However, it continued to maintain strict control over imports by licensing only those imports that were not produced or producible in the country.

Argentina ended up probably even more protectionist than it had been at the outset of military rule. It had made several general reductions in import duties and set as a policy goal to be achieved by 1984 a maximum 40 percent duty. In fact, the regime used the planned schedule of tariff reductions to compel industries to abide by price stabilization guidelines by threatening to lower import duties on a 180-day basis on competing foreign goods to the lowest level envisaged for 1984 instead of the current higher rates. This policy, together with the overvalued exchange rate created, according to Ferrer, "a negative protection" for several branches of the industrial sector.[33] The war with the United Kingdom over the Falklands in 1982 forced the regime to impose import and foreign exchange controls, most of which remained in force throughout the rest of the military's stay in office.

### STRENGTHENING THE PRIVATE SECTOR

The "liberal" (in the Latin American libertarian sense of the word) regimes believed that with proper incentives, the private sector could become the main force for dynamic growth. The Brazilian and Peruvian regimes also believed in strengthening the private sector. But they saw private enterprise more as a partner of the state than as the main agency of development.

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[32] Enders. Thomas O. and Mattione, Richard P., "Latin America: Th Crisis of Debt and Growth." The Brookings Institution, Washington, D.C., 1984, p. 65. This is the also the source for the public sector performance in Brazil, Argentina, and Peru. Enders and Mattione omit Uruguay in their study.

[33] Ferrer, Aldo, "The Argentine Economy: 1976-79," Journal of InterAmerican Studies and World Affairs, May, 1980, p. 144.

The liberal regimes believed sound monetary and fiscal policies and the removal of controls on business, foreign trade, and investment would stimulate the private sector to fulfill its role as the driving force for development.

For the statist regimes, the best way to help the private sector was to carry on with import substitution policies, and with foreign investment policies reserving part or all of the most promising growth areas of the economy to national entrepeneurs or to joint ventures of foreign and national firms.

In Argentina and Uruguay, the domestic private sector may have emerged from the military period in worse shape than before. In Chile still under military rule, it may also be weaker now than it was before the regime took power. At the same time, the role of foreign corporations probably expanded, since they had access to lower cost financing abroad which small and medium-sized national firms did not have. In addition, since they were the main exporters of manufactured products, they were also probably the main recipients of export subsidies needed to enable them to be competitive in world markets despite the overvaluation of the exchange rate. Overvalued exchange rates and lower import duties resulted in abrupt, massive import competition for domestic industry while government monetary policies drove real interest rates to unprecedented heights. Small and medium-sized firms which generally had little access to foreign loans were thus squeezed between a dwindling domestic market and the lack of working and investment capital that might have enabled them better to withstand foreign competition.[34]

In Peru, the private sector's role in the economy declined sharply under the military regime. As Fitzgerald has pointed out, the domestic private sector had already shrunk considerably between 1950 and 1968.[35]

Table 3, based on Fitzgerald's data, suggests that the growth of foreign corporations and, to a lesser extent, the public sector, was largely responsible for the decline of the domestic private sector. But the sharp decline in private investment in the 1964-68 period from the 1959-63 level, shown in Table 4, suggests that the domestic private sector was also deliberately reducing its holdings in the Peruvian economy.

TABLE 3.—PERU: CORPORATE SECTOR—PERCENT ACCOUNTED FOR BY DOMESTIC PRIVATE INDUSTRY, FOREIGN ENTERPRISES, AND PUBLIC SECTOR, 1950, 1968, AND 1975

| Sectors | 1950 | 1968 | 1975 |
|---|---|---|---|
| Domestic private | 72 | 51 | 40 |
| Foreign enterprises | 17 | 33 | 17 |
| Public sector | 11 | 16 | 31 |

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[34] For Chile, see Sigmund, "The Rise and Fall of the Chicago Boys," op. cit., p. 50; for Argentina, see Wynia, op. cit., p. 31, and Diamand, Marcelo," Overcoming Argentina's Stop and Go Economic Cycles," this volume, p.—; for Uruguay, see Weinstein, op. cit., p. 47.

[35] Fitzgerald, E.V.K., "State Capitalism in Peru: A Model of Economic Development and Its Limitations," in McClintock and Lowenthal, editors, op. cit., p. 70.

## TABLE 3.—PERU: CORPORATE SECTOR—PERCENT ACCOUNTED FOR BY DOMESTIC PRIVATE INDUSTRY, FOREIGN ENTERPRISES, AND PUBLIC SECTOR, 1950, 1968, AND 1975—Continued

| Sectors | 1950 | 1968 | 1975 |
|---|---|---|---|
| Cooperatives |  |  | 12 |
| Total | 100 | 100 | 100 |

Source: Fitzgerald, E.V.K., "State Capitalism in Peru: A Model of Economic Development and its Limitations," in McClintock and Lowenthal, op. cit., p. 70.

## TABLE 4.—PERU: AGGREGATE INVESTMENT, 1959–79

[Percent of GDP]

|  | 1959-63 | 1964-68 | 1969-73 | 1974-76 | 1977-78 | 1979 |
|---|---|---|---|---|---|---|
| Gross fixed capital formation: |  |  |  |  |  |  |
| Private | 15.3 | 10.8 | 7.9 | 8.1 | 8.3 | 8.3 |
| Public | 3.3 | 4.6 | 4.8 | 8.4 | 5.7 | 5.5 |
| Total | 18.6 | 15.4 | 12.7 | 16.5 | 14.0 | 13.8 |
| "Productive investment": |  |  |  |  |  |  |
| Private | 10.1 | 4.6 | 3.9 | 5.1 | 4.8 | 5.5 |
| Public | 1.7 | 2.4 | 3.1 | 7.2 | 5.7 | 4.5 |
| Total | 11.8 | 7.0 | 7.0 | 12.3 | 10.5 | 10.0 |

Source: Same as table 3, p. 72.

Fitzgerald does not offer an explanation for this. However, it is probable that the oligarchy which dominated the domestic private sector with its holdings of industrial and commercial firms as well as mining and agricultural enterprises feared nationalization and confiscation in its future and acted accordingly by transferring profits, depreciation funds and other liquid assets abroad.

These fears were not groundless. The reform-minded populist parties were growing in strength, but even more important, the social reform orientation of the military was known and confirmed in the military interregnum of 1962–63 when a land reform agency was established.

The military regime of 1968–79 banked on its import substitution policy, its selective controls over foreign investment, and its tax and subsidy programs to stimulate private investment by domestic firms. To some extent this happened, but the firms doing the investment were generally enterprises owned by a new class of entrepeneurs with few connections with the traditional oligarchy. Investment by these firms was not enough to bring private gross fixed capital formation up to the 1959–63 level or even to the 1964–68 level, although it was enough to raise private sector "productive" investment above its 1964–68 level.

### INCREASING AND DIVERSIFYING EXPORTS

The table below shows growth rates of exports in real terms for the B.A. countries in the 1960–70 and the 1970–82 periods. While these periods do not correspond exactly to the periods of military rule, they approximate them enough to furnish an indication of export performance.

TABLE 5.—SELECTED SOUTH AMERICAN COUNTRIES: GROWTH OF EXPORTS IN REAL TERMS

| | Regime | Average annual growth rates (percent) | |
|---|---|---|---|
| | | 1960–70 | 1970–82 |
| Countries: | | | |
| Argentina I | 1967–72 | 3.8 | |
| Argentina II | 1977–83 | | 8.3 |
| Brazil | 1965–84 | 5.3 | 8.8 |
| Chile | 1974– | .7 | 9.5 |
| Peru | 1968–80 | 2.1 | 4.8 |
| Uruguay | 1974–84 | 2.8 | 5.9 |
| Median, all upper middle income countries | | 5.4 | 7.1 |

Source: World Bank, "World Development Report 1984," Washington, DC, 1985, pp. 234–5.

Only South Korea and Jordan exceeded Chile's real export growth rate, and the growth rates for Brazil and Argentina were among the highest in countries classified by the World Bank as "Upper Middle Income Group." Peru is classified as a "lower middle income country" and did much better than the median for that group which declined from 5.3 percent in 1960–70 to 1.6 in 1970–82.

Comparative data are not available that include both exports of manufactured products and non-traditional primary products. The performance of the five regimes in promoting nontraditional exports is, accordingly, understated in the table below showing only exports of manufactures.

TABLE 6.—EXPORTS OF MANUFACTURES AS PERCENT OF TOTAL EXPORTS

| | 1960 | 1981 |
|---|---|---|
| Countries: | | |
| Argentina | 4 | 20 |
| Brazil | 3 | 41 |
| Chile | 4 | 10 |
| Peru | 1 | 17 |
| Uruguay | 29 | 30 |

Source: World Bank, "World Development Report 1984," Washington, DC, 1985, pp. 236–7.

None of the five countries came up to the weighted average of the upper middle group as of 1981, but the group includes the high performers like Hong Kong, South Korea, Israel and Yugoslavia, all of which had larger shares of exports of manufactures as of 1960 except for Uruguay. While Uruguay's exports of manufactures hardly increased in the 21-year period, it greatly improved the mix of its exports of manufactures, reducing the share of textiles and clothing (which are subject to fierce competition from the Far East and to severe restrictions in industrial country markets) from 21 percent of total exports to 13 percent. Moreover, Uruguay must have greatly increased its exports of non-traditional primary products. Weinstein writes that Uruguay increased its non-traditional exports from 25 percent in 1972 to 64 percent in 1978. Weinstein adds that non-traditional exports fell to 48 percent of total exports in 1980–81 and dropped "significantly lower" in the ensuing worldwide recession. [36]

The increase in the share of Peru's exports of manufactures from one percent in 1960 to 17 percent in 1981 was about the average for the lower middle-income group of countries whose exports of manufactures rose from four percent in 1960 to 18 percent in 1981.[37]

## THE MILITARY REGIMES AND THE ESTABLISHED DEMOCRACIES

In evaluating the economic performance of the military regimes, some standard is required. Since we are dealing with authoritarian regimes which many Latin Americans believed could better manage their economies than democratic governments, the best standard available is the economic performance of Latin American democratic countries during the same period of time.

In our view, five Latin American countries qualify as democracies. These are Colombia, Costa Rica, the Dominican Republic, Mexico and Venezuela. We have grouped these countries together under the rubric of "Established Democracies" or EDs. While Mexico's one-party rule makes it something less than a fully democratic country, its democratic forms, general respect for civil liberties, responsiveness to public opinion and the comparative latitude allowed opposition groups puts it into the democratic camp especially when compared with the military regimes of Central and South America.

Table 7 gives salient characteristics of the two groups of countries. The sharpest difference between the two groups is that Mexico and Venezuela are relatively large oil exporting countries. Their windfall foreign exchange gains as a result of the oil price boom of the 1970's should, therefore, have given them a great edge over the countries under military rule, all of whom are net oil importers. In fact, however, two of the BA countries, Argentina and Peru, produced enough oil of their own in the 1970's that they were able to reduce the oil import share of their total imports.

TABLE 7.—MILITARY REGIMES AND ESTABLISHED DEMOCRACIES: SELECTED DATA, 1960–82

| Countries | Population |  | Per capita GDP in 1982 U.S. dollars 1970 | Export as percent of GDP 1982 | Fuel imports as percent of of total imports |  |
|---|---|---|---|---|---|---|
|  | 1970 (million) | Annual growth rate percent 1970–82 |  |  | 1960 | 1981 |
| Military regimes: |  |  |  |  |  |  |
| Argentina | 24.0 | 1.4 | 2,065 | 6.1 | 13 | 11 |
| Brazil | 95.8 | 2.4 | 1,006 | 12.0 | 19 | 51 |
| Chile | 9.4 | 1.7 | 1,735 | 15.2 | (1) | 18 |
| Peru | 12.9 | 2.8 | 1,051 | 12.9 | 5 | 1 |
| Uruguay | 3.0 | .4 | 1,887 | 10.9 | 24 | 32 |
| Established democracies: |  |  |  |  |  |  |
| Colombia | 21.3 | 1.9 | 764 | 8.8 | 3 | 14 |
| Costa Rica | 1.7 | 2.5 | 1,313 | 43.5 | 6 | 16 |
| Dominican Republic | 4.0 | 3.0 | 788 | 16.7 | (1) | 33 |
| Mexico | 51.2 | 3.0 | 1.575 | 8.7 | 2 | (1) |
| Venezuela | 11.0 | 3.6 | 2.536 | 24.4 | 1 | 1 |

[1] Not shown.

Sources: (1) World Bank, "Atlas" computer rur, Feb. 8, 1985; (2) World Bank, "World Development Report 1984," (WDC), pp. 254–5; (3) Inter-American Development Bank, computer run, June 18, 1985; (4) Department of State. Bureau of Inter-American Affairs, "Economic Data Charts, 1986."

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[36] Weinstein, op. cit., 41.

[37] "World Development Report," op. cit. p. 236.

The windfall gains from oil may have helped Venezuela and Mexico in other ways, but they do not seem to have been of much help in expanding and divesifying the rest of their economies. The Venezuelan economy in terms of per capita GDP has not grown at all since 1970. Mexico became a large oil exporter only in 1975. The huge increase in its foreign exchange earnings since then was not accompanied by an increase in the growth rate of its per capita real incomes. On the contrary, even during the heyday of the oil price boom, 1973-81, Mexico's growth rate of per capita GDP was 3.4 percent as compared with 3.7 percent in the 1960-72 period, and if we take into account the full period of 1973-84, the growth rate averaged only 2.3 percent.

### *Growth and inflation*

There are other differences but they do not seem to confer any special advantage on the ED group. On the contrary, the economies of the EDs as a group were less developed than the BA countries and they had greater population pressures to contend with than the BA countries. They were also more dependent on exports than the BA countries. All in all, it does not seem unfair to compare the two groups of countries in economic performance.

Table 3 reflects the clearly superior performance of the EDs in 1950-69, a period roughly comparable to the pre-coup period of the BA countries. Real growth rates are generally higher, and inflation rates are much lower than in the latter countries.

### *Argentina and the EDs, 1966-73*

The two BA countries that outperformed the EDs in economic growth are Brazil and Argentina (in 1966-73). Brazil clearly outperformed all the other countries in real economic growth in the 1964-85 period as it also had done in the pre-coup era. The case of Argentina under the military regime of 1966-73 period is different. Its growth rate surpassed the rates of all the EDs if we use the much longer 1970-84 period for the EDs. But if we take the exact same period for both Argentina and the ED countries, then all the EDs except Venezuela did better than Argentina as the table below shows.

TABLE 8.—*Argentina and the established democracies: Average annual growth rates of per capita GDP, 1966-72*

| Country: | *PC/GDP* |
|---|---|
| Argentina | 3.0 |
| Colombia | 4.0 |
| Costa Rica | 4.3 |
| Dominican Rep. | 5.7 |
| Mexico | 3.3 |
| Venezuela | 1.6 |

Source: Inter-American Development Bank, *op. cit.* Rates calculated by author.

In the 1970-84 period, the EDs did better than the military regimes as a group but the margin of superiority was not as large as in the pre-coup era. In real economic growth, none of the EDs matched Brazil, which in both the pre-coup and military period outperformed all other Latin American countries. However, three EDs surpassed and a fourth equalled the next best performers of the military regimes, Chile and Peru.

The poorest performer in the ED group with respect to economic growth was Venezuela. But Venezuela's decline in per capita GDP was slight in comparison with that of Argentina in the 1976–83 period.

Moreover, Venezuela had the lowest inflation rate of the ten countries. While the EDs as a group did better than the military regimes with respect to inflation, the price increases of the 1970–84 period must have been especially shocking to the people of the EDs, given the low inflation rates of the 1950–1969 period.

*Other areas of performance*

In other areas of performance, the fragmentary data available permit only an impressionistic comparison between the military regimes and the democracies. This comparison can be summarized as follows:

(1) The EDs were about as reckless in borrowing abroad as the military regimes. As of 1982, the military regimes had increased their external debt by a factor ranging from 2.6 times the 1975 level for Peru to 6 for Argentina. In the EDs, the factors ranged from 2.9 times the 1975 level for Colombia to 5.8 for Venezuela.[38]

(2) The rate of growth of exports was slightly higher in the EDs in the 1970–80 period than in the military regimes, 20.4 percent and 16.9 percent, respectively. However, Mexico after 1974 and Venezuela throughout the decade were major oil exporters profiting from the oil price boom.

(3) The military regimes did better than the EDs in boosting non-traditional exports. Colombia, Costa Rica, and the Dominican Republic increased their non-traditional exports almost as much as the military regimes, but Mexico and Venezuela made virtually no progress in this area.

(4) The military regimes as a group did better than the EDs in improving public sector finances. Chile's public sector was in surplus in the first four years of the 1978–82 period. Venezuela's public sector generated surpluses in 1979 and 1980 but its deficit rose to 11 percent of GDP in 1982. Mexico's public sector deficit was high throughout the 1978–82 period. By 1982 it amounted to almost 19 percent of GDP, the highest ratio among the ten countries.

(5) Unemployment and real wage data for the two groups of Latin American countries under scrutiny are so poor, and the differences in demographic and socio-economic characteristics so great within each group that it is impossible to prove that one group performed better as a whole than the other. For example, two of the military regime group—Brazil and Peru—and four of the democratic group—Mexico, Venezuela, Costa Rica, and the Dominican Republic—had high rates of population growth. (2.5 percent or higher

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[38] Inter-American Development Bank, "External Debt and Economic Development in Latin America," Washington, D.C. 1984, p. 12. This source omits smaller countries. For Costa Rica, the Dominican Republic, and Uruguay, source is (public debt only) IDB 1985 Report "Economic and Social Progress in Latin America: External Debt Crisis and Adjustment," Washington, D.C. 1986, p. 424.

as compared with Uruguay, 0.5%. Colombia, 1.2%; Chile and Argentina, 1.7%.) In the high population growth countries, underemployment is a more serious problem than reported unemployment. A case in point is Mexico, for which one series shows unemployment varying from five to seven percent of the labor force in the 1975–85 period.[39] Another source, however, shows unemployment in the middle 1980s at 10 percent and underemployment at about 40 percent of the labor force.[40] Unemployment rose to 20 to 25 percent between 1979 and 1985, but even these large percentages probably understate the true size of the problem when underemployment is taken into account.[41] The underemployment problem is also large in Brazil and in Peru, and may be large also in Columbia, despite its low rate of population growth, because of its chronically high rates of unemployment varying from 10.6 percent in 1970 to 13.5 percent in 1985. Accordingly, official and quasi-official unemployment rates may be realistic for only five of the ten countries: Argentina, Chile, Uruguay, Costa Rica and Venezuela. Of these countries, Chile and Uruguay, the military regimes of which were the most rigorous in applying free market policies, had the highest rates of unemployment. In Chile, unemployment which was four percent in 1970, averaged 17.8 percent between 1974–82, and peaked at 27 percent in 1982.[42] In Uruguay, unemployment peaked at 15.5 percent in 1983. In 1970, it stood at 7.5 percent. It fell below this rate only once, in 1981, during the military regime period but rose sharply in 1982 and continued high thereafter.

Although real wage date for the ten countries under study are probably as impeachable as the unemployment data, a synthesis of the ILO and IDB data suggests the following percentage changes in average real wages occurred during the respective military regimes; for the democracies, the percentage changes in real wages are for the 1970–85 period deemed to be roughly comparable to the average item span of the military regimes.[43]

TABLE 9.—*Selected Latin American military regimes and democratic countries: Changes in real wages, indicated periods, 1964–85*

| *Countries* | *Average real wages percent change* |
|---|---|
| Military regimes: | |
| Argentina I (1966–1973) | 2 |
| Argentina II (1976–1983) | −51 |
| Brazil (1964–85) | 22 |
| Chile (1973–85) | −9 |
| Peru (1968–1980) | 6 |
| Uruguay (1973–1985) | −42 |
| Democracies: | |
| Colombia (1970–85) | 3 |
| Costa Rica (1970–85) | 10 |

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[39] Inter-American Development Bank, data sheet for unemployment and real wages chart. "Economic and Social Progress in Latin America: 1986 Report," (hereinafter referred to as IDB 1986) Washington, D.C., 1986, p. 227.

[40] Central Intelligence Agency. "The World Factbook," Washington, D.C., 1985, p. 155.

[41] Ibid. Unemployment rates for 1970–1980 for Chile and for Uruguay are from International Labour Office, Regional Employment Program for Latin America and the Caribbean (PREALC) "Mercado de Trabaljo en Cifras, 1950–80," Santiago, Chile, 1973; for 1980–85, the source is IDB, 1986 and data sheets for the unemployment graphics in that report. Unless otherwise specifically noted, these are the sources for unemployment rates drawn on for this section.

[42] French-Davis, Ricardo, "The Monetarist Experiment in Chile: A Critical Survey", "World Development," November 1983, p. 918.

[43] PREALC and IDB, op. cit.

| *Countries* | *Average real wages percent change* |
|---|---|
| Dominican Republic (1970-85) | −28 |
| Mexico (1970-85) | 9 |
| Venezuela (1970-85) | 6 |

Source: For 1964-80, PREALC, op. cit.; 1981-85 data represent PREALC 1980 level of real wages adjusted by applying IDB yearly percentage changes in real wages, 1981-85.

The averages mask the greater fluctuations of real wages in both groups of countries. For example, in Chile real wages reached a low point 38 percent below the 1970-72 average in 1975 but rose thereafter, reaching a peak of 21 percent above the average in 1981 and 1982.[44] The low level of real wages during the 1970s, however, brought the average level for the regime period down to nine percent below the pre-coup level. In Brazil, real wages reached a peak in 1980 of 65 percent above the pre-coup level but fell after that, bringing the average level of real wages for the 1964-85 period down to where they were only 22 percent above the pre-coup level.[45]

In the democratic group, the average level of real wages in Colombia in 1970-85 was only three percent, but the average wage level for the 1983-85 period was 15 percent above the base period (1967-69) level. In Mexico, real wages rose 28 percent between the base years, 1967-69, and 1977, but fell 37 percent between 1977 and 1985.[46]

## PART IV. INTERPRETATIONS

### THE EXPERIENCE OF MILITARY RULE

The experience of the people of Argentina, Brazil, Peru and Uruguay with their recent military regimes and of the Chilean people with their still incumbent military dictatorship has probably been the most traumatic in their twentieth century history. By the same token it may prove to have been the shock that was needed to bring political stability and sustained economic growth.

The military regimes, particularly those of Argentina, Chile and Uruguay, caused suffering on a scale unprecedented in these countries. Thousands of people were tortured and executed, and other abuses of human rights were systematically committed. In addition, monetary stabilization policies of the military regimes in Chile and Uruguay and in Peru in the 1976-79 period caused high unemployment, and in these three countries and in Argentina large losses in real incomes of large numbers of people.

As a result of these experiences, the presumption is that civilian political leaders, many of whom themselves suffered directly under the military regimes, will no longer be as prone as they were in the past to turn to the military for help when things are not going their way under the parliamentary system. With the military option ruled out, civilian political leaders may henceforth work harder than they ever have done before to settle their differences under the rules of democratic politics.

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[44] Source for pre-coup average (1961-63) is Foxley, Alejandro, "Latin American Experiments in Neo-Conservative Economics," University of California Press, Berkeley, 1983, p. 122.

[45] No complete series is available for the ten countries for the 1964-85 period. The IDB series covers 1975-85, but shows only annual percentage changes, gives no base year value and omits 1983 and 1974 data.

[46] It bears repeating that these percentages and probably all Latin American real wage data are little more than informed guesses. Despite the importance of good wage and unemployment data, Latin American governments have generally shown little interest in improving the quality of these statistics, and the regional and international organizations to which they belong seem to have been equally unconcerned.

The military regimes achieved one of the four main goals they had set for themselves. They attained their security goal by eliminating the immediate threats confronting their countries—although it is arguable that they could have done this without prolonged and repressive military rule. They failed in their other three goals: depoliticizing their people, achieving rapid economic growth and ending chronic inflation.

With respect to depoliticization, they were forced by public opinion, except in Chile, to restore civilian rule and to see voters reaffirming their allegiance to the very parties or similar parties which the military had held responsible for the chaotic economic and political conditions that had prompted them to intervene in the first place.

With respect to economic growth, none of the regimes except the Brazilian succeeded in bringing about significant expansion, and in Chile, Argentina and Uruguay, regime policies actually may have reduced domestic industrial capacity.

As to inflation, only the Chilean regime succeeded in bringing it down significantly and keeping it down. All the regimes failed to set prudent limits to private and public borrowing abroad. In Chile, Argentina and Uruguay, exchange rate and credit policies encouraged financial and exchange rate speculation and capital flight that diverted resources away from investment in industry and agriculture.

All things considered, the democratic countries did not do much better. They also borrowed excessively abroad and in general also failed to use borrowed funds wisely, boosting consumption at the expense of investment to increase and diversify the productive capacity of their economies. On the whole, they did better in economic growth and in keeping inflation lower than the military regimes did. However, the wide range in stages of development and national income within each of the two groups makes untenable a categorical judgment about which was superior to the other in economic management. What can be said with some confidence is that the South American experience with authoritarian economic management was clearly not better than the management of the democratic countries of the period, or even of the civilian governments that preceded the military regimes.

Table 10 presents an over-all view of per capita GDP and of inflation under the military regimes. The democratic countries are omitted from this table because of the complexity that would result from trying to include the exact time periods for each democratic country that would match the time periods of each of the military regimes. A rough comparison of the two groups of countries was provided in Table 2 using arbitrary time periods for the democratic countries. However, the use of the arbitrary time periods can be misleading. For example, in Table 2, the period chosen (1970–84) for the democratic countries showed the Argentina regime of 1966–73 outperforming all the democratic countries in growth. However, when the growth performance of the democratic countries over the exact same period was considered, four of five democratic countries surpassed Argentina's growth performance. Table 10 differs from Table 2 in other respects also: (1) GDP data in Table 2 were in terms of 1982 dollars and in Table 10, they are in terms of 1984 dollars; (2) Table 2 shows average annual rates of change; Table 10 shows the cumulative change between the beginning and ending years of the military regimes.

TABLE 10.—SOUTH AMERICAN "NEW-STYLE" MILITARY REGIMES: REAL PER CAPITA GDP AND INFLATION RATES, LAST FULL PRE-COUP YEAR AND LAST FULL REGIME YEAR

| Country | Base year: Last full pre-coup year | Base year |  | End year: Last full regime year | End year |  | Base year to end year percent change |  |
|---|---|---|---|---|---|---|---|---|
|  |  | P/C GDP (1985 U.S. dollars) | Inflation rate (percent) |  | P/C GDP (1985 U.S. dollars) | Inflation rate (percent) | P/C GDP | Inflation rate |
| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
| Argentina I | 1965 | 1,973 | 26 | 1972 | 2,276 | 59 | 15.4 | 126 |
| Argentina II | 1975 | 2,356 | 443 | [a] 1983 | 2,080 | 334 | −11.7 | −25 |
| Brazil | 1963 | 897 | 71 | 1984 | 1,754 | 197 | 96.0 | 177 |
| Chile | 1972 | 1,945 | 79 | [b] 1985 | 1,817 | 31 | −6.6 | −61 |
| Peru | 1967 | 1,099 | 22 | 1979 | 1,055 | 67 | −4.0 | 204 |
| Uruguay | 1972 | 2,026 | 76 | 1984 | 2,205 | 55 | 8.8 | −28 |

[a] Jan. 1 to Dec. 12, 1983.

[b] Regime still in power; 1985 was last full year for which final data were available when this table was prepared.

Sources: GDP data, Inter-American Development Bank; inflation rates, "International Financial Statistics" International Monetary Fund, December 1980, and June 1986.

## EXTERNAL SHOCKS

External shocks played a larger role in the mixed economic perforemance of the military regimes—and of the democratic governments of Latin America as well. The OPEC oil-price boast of 1979, the world recession of 1981–83, the steep rise in interest rates and the sharp reduction in new loans of that period were largely responsible for the severe recession that occurred in the five countires during the early 1980's.—and in the rest of Latin America and all the other developing countries as well. But some countries by extraordinary adjustment efforts were able to minimize the impact of the shocks, while others carried out policies that magnified them. Brazil, according to Enders and Mattione was a highly successful adjuster, cutting the vast potential damage of the external shocks by half by taking measures to increase exports and reduce imports. In Chile, on the other hand, the policies followed not only did not minimize the external shocks but magnified them. Argentina did even worse: although it benefited to the extent of a billion dollars from positive external shocks, as a result of a great improvement in its terms of trade, its cumulative current account deficit in the 1979–82 period was $13.4 billion. Peru received a windfall gain of $400 million largely because it was a small exporter of petroleum. By a successful adjustment, it improved the current account by $1.3 billion. In contrast, Mexico and Venezuela, transformed large positive shocks into huge current account deficits.[47] Table 11 shows how the seven largest Latin American countries adjusted or failed to adjust to the external shocks.

TABLE 11.—7 LATIN AMERICAN COUNTRIES: ADJUSTMENT AND DISADJUSTMENT TO EXTERNAL SHOCKS, 1979–82

[In bilions of U.S. dollars]

| | Adjustment | Cumulative shock | Current account change |
|---|---|---|---|
| Country: | | | |
| Brazil | Successful | −48.5 | −23.6 |
| Colombia | do | −6.8 | −6.6 |
| Peru | do | .4 | 1.3 |
| Mexico | Unsuccessful | 11.7 | −18.7 |
| Venezuela | do | 19.5 | −13.0 |
| Argentina | do | 1.0 | −13.4 |
| Chile | do | −4.8 | −8.5 |

Source: Adapted from "Table 5, Enders and Mattione," op. cit.p.11. Successful adjustment, according to the 2 authors, is keeping the external shock's damage to the current acount below the calculated dollar amount of the external shocks in the case of shocks exerting an adverse impact on the current account. In the case of "positive" shocks, successful adjustment consists of improving the current account by at least the amount of the positive shock.

The recession that began for some of the military-governed countries in 1980 and for others in 1981 and which after several years of trying, the regimes were not able to overcome, was a major factor in the decision of the armed forces to restore civilian rule. Until the recession, increasing numbers of citizens had manifested their opposition to military government in all the countries except Chile. In part this opposition was based on resentment over the loss of political freedom, but in part also it was based on economic mismanagement, and in the case of Argentina, on the military's mishandling of the war with the United Kingdom over the Falklands. Until the recession hit, however, the military may still have believed they had enough support to continue in power indefinitely. The recession was the crowning blow to the military's credibility as effective managers of the economy. While the people of the region might have accepted the economic crisis of the 1980's as something beyond the control of their rulers, in the countries run by the military the latter were held responsible, justly or unjustly, for the severity of the depression, and for their inability to overcome it quickly. The military had assumed exclusive responsibility for the economy, and, except in Brazil, had paid little heed to the complaints and warnings of almost all the major economic interst groups that made up their societies. Moreover, the armed forces had claimed full credit for the boom times of the 1970's through these were to a substantial degree made possible by the over-expansion of the world economy and the greatest borrowing spree in Latin American history.

## ADJUSTMENT UNDER THE MILITARY AND POST-MILITARY REGIMES

The depression that began in 1981–82, from which only Brazil of the five countries had emerged as of 1985, may well have been the worst in the modern history of these countries, not barring the depression of the 1930's. In Argentina, per capita GDP fell 8 percent in 1981 and another 6.8 percent in 1982. In Brazil, per capita GDP in 1983 was almost 11 percent below the 1980 level. Per capita output in Chile fell almost 16 percent in 1982 from the 1981 level and another two percent in 1983. In Peru, per capita output fell 14 percent in 1983 from the 1982 level. In Uruguay, per capita GDP in 1982 fell 10 percent and continued to fall. Per capita GDP in 1984 and 1985 (it remained about the same in the two years) was 18 percent below the 1981 level.[48] To make matter worse, all the countries except Peru had large trade and current account deficits in 1980 and 1981. In 1980, debt service (amortization and interest) exceeded new loans by $10.3 billion for the four countries, Argentina, Brazil, Chile and Peru, and in 1982, the outflow of funds from the four countries exceeded inflow of funds deriving from loans by $16.3 billion.[49]

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[47] Enders and Mattione, op. cit., p. 20.

The five countries, of which only Peru had reverted to civilian rule as of 1980, were then forced to cut imports and increase exports to the maximum. Their combined trade balances were slashed from a deficit of $4.6 billion in 1980 to $200 million in 1981 and into a surplus of $4.8 billion in 1982, $12.4 billion in 1983, $18.4 billion in 1984, and $19.3 billion in 1985. The combined surplus for the five countries may be roughly about the same level, judging from preliminary trade data for the first half of 1986.[50]

The adjustment which the five countries have made to the changed conditions of the 1980's has been painful. With foreign loans and foreign investment greatly reduced from the levels of the late 1970's, the burden of external adjustment has had to fall on foreign trade. The reduction in imports together with deflationary policies have meant depressed investment levels and continued stagnation. In 1985, Brazil was the only country in Latin America where per capita GDP growth was substantial, 5.6 percent. Two others, Colombia and Panama had positive per capita GDP growth, 1.5 percent and one percent, respectively. Eleven countries had negative growth rates; one had zero growth, and four had increases in per capita GDP of less than one percent. What these figures do not reveal is the impact on the poorer people of these countries because of the reduction of the social welfare expenditures, the hardships of increased unemployment, the impact of cuts in the educational budgets, and the sharp reduction in investment on which future growth depends.

The reduction in the flow of loans to the five countries and the need to use so much of foreign trade earnings to pay interest need not have had such an adverse impact on the five economies if world commodity prices had responded more to the recovery of the industrial economies. The consequence is that although four of the five countries—Peru is the exception—greatly increased the volume of their exports, Brazil is the only one to have come anywhere near increasing its export earnings correspondingly. Argentina, for example increased the volume of its exports between 1981-82 and 1985 by 27 percent, but its export earnings increased only 0.2 percent. Chile increased the volume of its exports by 23 percent but its export earnings fell 3.5 percent during the period. Table 12 also shows reductions made in imports, ranging from 36 percent to 47 percent below the levels of 1981-82.

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[48] Inter-American Development Bank, "Economic and Social Progress in Latin America: 1986 Report," Washington, D.C., 1986, September, 1986.

[49] Calculated on the basis of data presented in "External Debt and Economic Development in Latin America: Background and Prospects," pp. 88–96.

[50] Trade data 1980–84, International Monetary Fund, "International Financial Statistics," June, 1976; 1985 data and first six months, 1986, International Trade Administration, Department of Commerce, Washington, D.C.

TABLE 12.—SELECTED SOUTH AMERICAN COUNTRIES: INDICATORS OF ADJUSTMENT EFFORT, 1981–85

| | Real per capita GDP: Percent change from 1981-85 [1] | 1985 Exports: Percent change from 1981-82 average [2] | | 1985 Imports: Percent change from 1981-82 average [2] | |
|---|---|---|---|---|---|
| | | Value | Volume | Value | Volume |
| Countries: | | | | | |
| Argentina | −10.2 | 0.2 | 26.7 | −45.4 | −43.4 |
| Brazil | −1.0 | 18.0 | 27.6 | −36.4 | −26.4 |
| Chile | −13.6 | −3.5 | 23.1 | −42.1 | −34.8 |
| Peru | −14.9 | −8.3 | −6.7 | −46.8 | −45.5 |
| Uruguay | −17.9 | −24.0 | 11.6 | −41.1 | −46.1 |

[1] Inter-American Development Bank, Computer run, Sept. 19, 1986.
[2] Morgan Guaranty Trust Co. of New York, World Financial Markets, February 1986.

### THE FIGHT AGAINST INFLATION

All five countries made great efforts to reduce inflation. In Chile, monetary and fiscal policies to keep inflation under control have been rigorously pursued since the inception of the military regime in 1973. But it took the regime four years to bring inflation down from 350 percent to below 100 percent, despite one of the harshest "shock therapies" ever undertaken in Latin America. Inflation was cut to 40 percent in 1978, then brought down in stages to a low of 9.9 percent in 1982. The inflation rate rose to 27 percent in 1983, fell back to about 20 percent in 1984, and rose again in 1985 to 31 percent. In 1986, the rate appears to be falling again.

At one time or another all the military regimes endeavored to control inflation principally by cutting the rate of growth of the money supply; only Chile, however, rigorously adhered to the policy. The Argentine regime abandoned the policy in 1981. The Brazilians kept the rate of monetary growth in the 30 to 40 percent range in 1975–78. Tracing a very irregular pattern marked by sharp surges, the Uruguayan regime brought the annual rate of growth of the money supply down to about 20 percent in 1981–83, but after that the money supply increased more rapidly. The Peruvian regime tried to restrict the growth of the money supply after 1975 but did not succeed until late 1978. It and the Belaunde government that followed it brought the annual rate of inflation from 80 percent in late 1978 to about 40 percent in 1982. The Belaunde government then apparently lost control or was unwilling to continue with the policy, and the money supply increased rapidly.

The rhythm of inflation corresponded rather closely to movements of the money supply in all the five countries, except in Peru in the 1980–82 period. There consumer prices did not fall, although the rate of growth of the money supply fell sharply in that period. After 1981 inflation accelerated sharply in Argentina, and after

1982 in Brazil and Peru. In Uruguay, inflation rose sharply in 1983 and after, but did not attain the speed of inflation in Argentina, Brazil and Peru. Table 13 brings out the course of inflation in the five countries.

TABLE 13.—SELECTED SOUTH AMERICAN COUNTRIES: INFLATION RATES, 1981–86 AND CHANGES IN PER CAPITA GDP, 1981 AND 1985

[Percent change]

| | Inflation rates from previous year | | | Per capita GDP to 1985 from— | |
|---|---|---|---|---|---|
| | 1981 [1] | 1985 [1] | 1986 [2] | 1980 | 1981 |
| Countries: | | | | | |
| Argentina | 131 | 385 | 50 | −17.4 | −10.2 |
| Brazil | 95 | 235 | 20 | −3.7 | 0.3 |
| Chile | 10 | 26 | 25 | −10.3 | −13.6 |
| Peru | 73 | 158 | 85 | −14.4 | −14.8 |
| Uruguay | 29 | 83 | 72 | −16.7 | −17.9 |

[1] Morgan Guaranty Trust Co. of New York, "World Financial Markets, February 1986." December to December rates.

[2] Estimated annualized rates based on information provided by Bureau of Inter-American Affairs, Department of State, as of June 25, 1986. Projected Brazil rate is author's and is based on Janauary to February rates and estimates in Wall Street Journal, Nov. 25, 1986.

## THE 1985–86 SITUATION

In Argentina and Brazil, the sharp drop in inflation is the result of the stabilization programs undertaken in June, 1985 in Argentina and in March, 1986 in Brazil.[51a]

The great adjustment efforts which the governments of the area have been making for several years had not paid off as of 1985, except, as noted before in Brazil in any substantial degree of recovery from the recession that had begun in the early 1980s. In 1986, however, per capita GDP in Peru and Brazil is expected to grow by 6.4 and 4.8 percent, respectively; Chile may realize 2.8 percent growth; and Argentina and Uruguay may experience an increase of from one to two percent.[51b] On the basis of preliminary data for the first half of 1986, Brazil and Chile are expected to increase their trade balances as a result of increased exports and reduced imports. The decline in oil prices has enabled the two countries and Uruguay to use the foreign exchange saved on oil imports to increase reserves or purchase other imported goods needed for investment and growth. On the other hand, Argentina and Peru are likely to have smaller trade balances in 1986 than in 1985. Since both Argentina and Peru are small net exporters of oil, lower world oil prices are working to reduce their export earnings.[52]

All five countries have benefited from lower interest rates on their external debt refinancing. In the case of Brazil, this has meant a huge reduction in interest payments, from $11.1 billion in 1985 to a projected $8.9 billion in 1986.[53] The other countries of the region may not realize proportionate savings because they may not have as much of the their foreign debt priced on a floating rate basis as Brazil does. Nevertheless, other countries have ratios of short-term debt to total debt higher than Brazil's which suggests that they should also realize substantial savings in interest payments.

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[51a] The Brazilian program collapsed in the last quarter of 1986 and inflation rose to an annual rate of 1000 percent by June 1987 when a new price freeze was imposed.

[51b] For Brazil and Chile, projections are from Economic Data Charts, Department of State, Bureau of Inter-American Affairs: for Argentina, source is International Trade Administration, United States Department of Commerce; for Uruguay, source is Bureau of Inter-American Affairs, Department of State; for Peru. Source is Washington Post, February 10, 1987, p. C-3.

[52] Department of Commerce, International Trade Administration, Washington, D.C.

[53] Morgan Guaranty Trust Company of New York, "World Financial Markets," August, 1986.

## CONDITIONS FOR SUSTAINED GROWTH

The continued economic recovery of the five countries beyond 1986 depends in the shorter run primarily on external factors beyond their control. That is definitive recovery from the recession of the 1980's depends on low petroleum prices, increasing demand for Latin America's exports of primary products, and an increase in lending by foreign financial institutions. In the longer run, growth depends on attitudinal and institutional changes that will give the private sector a favorable environment for expansion and for attracting foreign investment.

In the shorter run, increasing exports is one solution for emerging from recession and for resuming the growth path. But the five countries along with most other Latin American countries will have to alter their export mix in favor of industrial products if they are to assure themselves of a steadier flow of export earnings. Increasing exports requires not only increasing investment in industries with export potential but also steady, substantial growth in the industrial countries and a standstill or actual reduction in their trade barriers. Even under these favorable conditions, however, the Latin American countries can not develop their industrial export potential quickly enough to pay for the imports they need now for growth. Moreover, they have social needs to attend to if they are going to develop the consensus required for political stability. These considerations argue for increased lending to the region and, for some countries, more debt relief then they are currently getting.

The stress in the foregoing section on external factors does not mean that domestic policies are unimportant. As crucial as these are for long-term growth and political stability, though, they are of lesser urgency in the short-term because the governments have had no choice but to pursue non-expansionary policies.

## CURRENT ECONOMIC POLICIES

It is not surprising that the Chilean regime has been able to persevere with such policies, given its coercive power. What is surprising is that democratic governments—with the exception of that of Brazil, where stabilization policy since 1983 has not entailed much austerity—have been able to carry on with policies that have hampered growth for the last four or five years. Since there has been no substaintial opposition to these policies up to now, it would seem except for Peru, that the general public and other political leaders do not see any acceptable alternative to the priorities established by their governments of subordinating the goals of growth and social equity to re-establishing the full international creditworthiness of their countries.

How long this mood will last is uncertain. Much depends on the pace of recovery being sustained in the region in 1987. If recovery falters, it does not seem likely that the people of these countries will be content to go along with governments that do not appear to have the key to economic health.

The Brazilian public apparently thought their leaders were on the right track or they would not have given such a large measure of support to President Sarney and his party in the November 15, 1986 congressional and gubernatorial elections. But up to these elections, Brazil's policies had not been contractionary. On the contrary, by restricting the inflation-indexing system for savings instruments and initially raising wages upward while freezing prices, the government stimulated an unintended consumers' spending boom. This eventually created great upward pressures against price ceilings and led to the usual fall-out of price-control systems that last too long—shortages and deteriorating quality of goods, smuggling the black markets. To halt the erosion of the program, the Sarney government on November 21, 1986 decreed steep new tax increases, raised public utility tariffs and price control ceilings and further restricted the inflation-indexing system. The new and unpopular package illustrates how growth generates problems of its own. It creates more demand for imports and it tends to reduce exports as an increasing share of output is likely to be diverted to satisfying the increased demand for the home market. It also intensifies demands for higher wages and new pressures for more attention to social needs.

How well the democratic governments meet the challenge of developing an effective economic strategy for growth and for social needs depends on the durability of the political consensus that has backed them so far. Differences over economic and social policy may become sharper in a period of growth than in recession. The grounds for hope that the democratic consensus will hold is that the military as well as civilian conservatives and reformers may have learned lessons from their experiences with the military regimes that will make it easier for them to agree on national policy or if they disagreed with it, work to change it within the system rather than resort to military intervention.

## LESSONS OF THE MILITARY REGIME EXPERIENCE

One lesson may be an increased awareness of economic limits—what Hirschman, referring to Latin American experience, has termed "the low propensity of the policy-makers to defer to normal economic constraints." [54]

While this tendency was most pronounced in the populist governments of the pre-coup era, the military regimes also were guilty of ignoring economic constraints in raising arms expenditures and in accumulating external debt beyond the normal capacity of their economies to service fully without sacrificing growth. The military regimes were not alone in assuming that the boom times of the 1970's would continue indefinitely, but the years of governing and the subsequent shrinking of military budgets under democratic governments may have made the military more conscious of economic limits, than before. On the populist side, the fact that for the first time in recent history populist politicians have had to execute contradictory policies whether they liked to or not may have made them more realistic about economic affairs.[55]

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[54] Hirschman, Albert O., "The Turn to Authoritarianism in Latin America and the Search for Its Economic Determinants," in "Essays in Trespassing: Economics to Politics and Beyond," Cambridge University Press, Cambridge, 1981, p. 105.

A second lesson is the importance of remaining pragmatic in developing and applying policies to solve current problems. Uncertainty of outcomes is a hallmark of democratic thinking, Hirschman contends, as is tentativeness of policy decisions. He explains:

> Many cultures—including most Latin American ones I know—place considerable value on having strong opinions on virtually everything from the outset, and on winning an argument rather than on listening and finding that something can occasionally be learned from others. To that extent, they are basically predisposed to an authoritarian rather than a democratic politics . . . The recent authoritarian regimes in Argentina, Brazil and Uruguary can be understood in part as the final outcome of a politics where both of these uncertainties were wholly absent from the minds of the principal political actors. The current revulsion against those regimes could imply a questioning of these mental habits, however deeply entrenched they may have been.[56]

A third lesson emerging from the experience of the last two decades in South America is that governing exacts an enormous toll on the military themselves. It is just possible that each of the military establishments decided to withdraw from power just in time to prevent splits in their ranks from being resolved by armed conflict. Purges, even assassinations and executions of military officers opposed to the coups took place in Brazil and Chile. Purges of high officers took place in 1975 in Peru when General Velasco was ousted. In Argentina, military coups within military coups have occured every time the military has been in power. In 1962, the conflicts between "hardliners" and constitutionalists actually led to a brief but potentially dangerous armed encounter. After Argentina's defeat in the brief war with the United Kingdom in 1982 the bitterness among the services led to the withdrawal of the navy and air force commanders from the ruling junta.

A fourth lesson is that economic growth is no guarantee of political success. Even after years of high growth performance, the electorate in all the countries except Chile showed their unmistakable opposition to the military regimes whenever they had a chance to do so. In Chile, the only electoral test took place in 1980 when Chileans were asked to approve a new constitution that would in effect extend Pinochet's rule until 1997. The plebiscite was approved, according to the government, by a 60 percent majority. Valenzuela challenges the validity of the vote on the grounds that no voter registration took place and the regime monopolized television coverage before the vote. In any case a public opinion poll taken in November, 1984 showed how unpopular General Pinochet and his regime had become. In 1984, 69 percent of the respondents favored an immediate return to democracy by 1985, and only 5.8 percent of the respondents selected Pinochet as the best leader to solve the country's problems.[57]

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[55] The collapse of the Sarney government's anti-inflationary program of 1986–87 casts doubt on whether the Brazilian leaders have become more realistic.

[56] Hirschman, Albert O., "On Democracy in Latin America," New York Review of Books, April 10, 1986. Hirschman cites Bernard Manin, the French political theorist, and Adam Przeworski for their concepts of uncertainty of outcomes. The Manin article is "Volonte generale ou deliberation? Esquisse d une theorie de la deliberaton politique," Le Debat, No. 22, (January, 1985); forthcoming in English in Political Theory. Przeworski's article appeared in a Portuguese journal, Novos Estudos CEBRAP, July 1984, with the title, translated in English by Hirschman as "Love Uncertainty and You will be Democratic."

The fifth lesson is that the ideological direction of a future military regime and the degree of its repressiveness are unpredictable. The Peruvian regime of 1968–75 is an example. While it was the least repressive of the military regimes, it carried out a social revolution that destroyed the power of the large land-owners and the political influence of foreign corporations operating in Peru. Another example has to do with the represssiveness of the armed forces in the other countries. Nothing in their past conduct would have led the ordinary observer beforehand, and perhaps many of the military officers themselves, to believe that the armed forces of Argentina, Chile, and Uruguay would resort to terror as a routine method of governing.

## THE PRESENT CONSENSUS

The present consensus will be sorely tried over the next few years. Apart from difficult domestic issues, such as agrarian reform, taxation, wage policy, and social reforms, critical problems in the relations of the five countries with the industrial nations will continue to be troublesome: the handling of the external debt; export subsidies; protectionism on both sides; the conditions attached to new lending by the international financial agencies and the commercial banks; and host government policies with respect to foreign investment. Of these, the debt problem is probably the most explosive. By all kinds of ad hoc arrangements the debt problem has been managed so far, except in the case of Peru, which under the Garcia government, has suspended virtually all interest payments to foreign commercial banks. In the other countries, there has been just enough refinancing and rescheduling of maturities to permit debtor countries to meet most of their interest payments; there has been little repayment of principal.

## NATIONALISM AND THE PRESENT CONSENSUS

If the economies of the industrial nations continue to improve, Latin America's export earnings should increase, and the debt problem should become easier to manage. However, whether, the countries' trade balances will improve enough and soon enough to permit more expansionary policies is uncertain. If recovery falters in Brazil and Chile and does not proceed more speedily in Argentina, Peru and Uruguay, the present governments are likely to come under increasing pressure from nationalist groups to take a more aggressive stance with creditor institutions and governments.

To nationalists, this poicy must seem to be a manifestation of the continuity of the internationalist orientation that marked the military regimes of Argentina, Brazil (until April, 1967), Chile and

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[57] Constable, Pamela and Valenzuela, Arturo, "Is Chile Next?", Foreign Policy, Summer, 1986, pp. 63–70. The two authors conclude that there is little chance that Pinochet will be forced out of office any time soon, despite his unpopularity. They attribute Pinochet's hold on power to continuing military and business support, the divided state of the opposition and the general fear of the resurgence of the extreme left.

Uruguay. By borrowing heavily abroad, the military regimes gave foreign creditors and governments a power over domestic policies without parallel since at least the 1920's, and even, perhaps, since the 1880's and 1890's. By doing all they could to attract foreign investment, the regimes ignored, not only their domestic business communities but also many in the military establishment itself, the most dedicated and organized nationalistic force in their own countries.

In Peru, there had been no contradiction between regime policy and the nationalism of the military establishment; in fact it was the appeal to their nationalistic attitudes that made it possible for the Velasco regime to use the military as the instrument of social revolution. In Brazil, unity within the military establishment had been achieved by the adoption, after General Castello Branco's term had expired, of an essentially nationalistic development program. In Chile, the internationalist policies prevailed because of the personal convictions of General Pinochet and his enormous power over the Chilean military. In Argentina and Uruguay, the issue was probably not foreign investment itself or even the advisability of free market reforms but the opposition of the military to a drastic reduction of the public sector. In part the opposition was based on the self-interest of military officers, both those on active duty and retired, who held important positions in the state enterprises and in the central bureaucracy. In part, the opposition was based on the Hispanic patrimonial tradition in which the state plays a central role in economic life. Whichever of these influences may have been dominant in the military's opposition to cutting back the public sector, this opposition in fact doomed the efforts of the civilian ministers to transform their countries into free market economies.[58]

## THE FUTURE OF LIBERALIZATION

Despite the failure of the military regimes with all their coercive power to restructure their economies along free market lines, economic liberalization is not a hopeless cause in South America. At present there is probably not much of a constituency for liberalization in Argentina and Uruguay because it was associated with military repression, business bankruptcies and lower living levels for the population. Additionally, in Argentina, it was identified with the humiliating defeat of the brief but costly war with the United Kingdom over the Falklands; and in Uruguay by massive, unprecedented unemployment. Because of the hardships already caused by the liberalization process in Chile, that policy may be suspended or even reversed if civilian rule is restored soon. On the other hand, if the Chilean regime can stay in power long enough, persevere in its efforts to liberalize the economy and can keep the economy growing for a decade or so, with rising real incomes and low unemployment, a market economy may emerge that will command the loyalty of the Chilean people.

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[58] The following comment by Wynia refers to Argentina, but it is applicable to Uruguay as well: in the post-World War II period no Argentine president, civilian or military, has been able to control public sector deficits. Wynia writes: "At the end of his term (1976-80) as (economy) minister, Martinez de Hoz admitted that the size of public sector spending and the ability of vested military and civilian interests to block its reduction were the greatest obstacles to his program." Wynia, Gary W., "The Argentine Revolution Falters," Current History, February, 1982, 1982, p. 75.

What gives ground for hope about the future of liberalization is that the leaders of the four democracies and their key advisers seem to be agreed on the need to reduce the role of the state in economic affairs and to create the conditions for private enterprise to take over as the driving force of the economy. What they have to do is convince the people of their countries that structural reforms to this end are called for. This they may not be able to do until they get their economies on a growth path and keep them there, gradually stepping up the pace of reform. This sequence runs counter to the view that debt relief and the resumption of foreign lending and investing must be conditioned on progress toward liberalization. However, in view of the great resistance to liberalization demonstrated by the experience of Argentina, Brazil, and Uruguay, it seems unlikely that free market reforms could get very far in a depressed economy. In such a context privatizing huge state enterprises—assuming the private sector is willing to buy them—dismissing tens of thousands of government and parastatal employees, pushing industrial firms into bankruptcy by too hastily lowering the protection that permitted them to be established in the first place, constitute a recipe for economic and political disaster.

## THE PRIVATE SECTOR IN PERU

Oddly enough, the two military regimes that eschewed the liberalization route, the Brazilian and the Peruvian, in bringing about the growth of the private sector in their respective countries may have shown the best way to bring about liberalization. In contrast, the military regimes of Argentina, Chile and Uruguay in their attempt to make their industrial sectors more competitive in world markets went too fast and even perversely (in overvaluing their exchange rates) and ended up with weakened entrepreneurial sectors. The case for the Peruvian regime rests not on its over-all growth performance, which was poor, but on its social reforms and industrialization drive. The case for Brazil is based primarily on its growth performance.

According to Lowenthal, the Peruvian programs had the effect of creating a new class of technocrats and entrepreneurs. The regime virtually destroyed the power of the traditional elites which controlled so much of the Peruvian economy—the large plantation owners, the established businesses and industries and foreign corporations. All these, he contends, lost their influence over Peruvian affairs, as have also the United States; and the military themselves "are on the defensive, discredited, widely disdained, credibly accused of corruption and incompetence, wary about getting drawn back into the political vortex." He holds that power has shifted in part to the new technocracy that developed as a result of the expansion of the government's role under the military regime. In part also, power has gone to what Lowenthal terms the "mobilized populace", trade unions and organized rural workers and farmers. But it is the third new power holder that is relevant to the prospects for liberalization. Lowenthal writes:

> Where has all the power gone? In part, to new entrepreneurs who have made a great deal of money during the past decade, mainly in import substitution industries, in mining, in real estate. New "first families"—nationally oriented, aggressive, and conspicuous—have begun to emerge in Lima . . . Less tied to foreign interests than previous elites, more oriented toward the production of consumer goods and less inclined to rely on interlocking financial networks to assure their wealth, these newly rich Peruvians could help change Peru in the years to come if they are able to provide the entrepreneurial dynamism the country has always lacked.[59]

Schydlowsky is not as explicit as Lowenthal about the emergence of a new entrepreneurial class in Peru as a result of the experience under the military regime, but the thrust of a recently published article seems to support the Lowenthal thesis. Schydlowsky writes:

> Between 1976 and 1979, nontraditional exports grew by a stunning 453 percent from $137 million to $756 million. Industrialists who had never thought they could penetrate foreign markets suddenly found themselves exporting substantial amounts not only to neighboring countries but also to the United States and Europe. Government officials who had been convinced that Peruvian industry was hopelessly inefficient, began to think otherwise. Long-held convictions about Peru's limitations as a potential industrial producer were suddenly abandoned and reversed.[60]

## THE PRIVATE SECTOR IN BRAZIL

In Brazil, the promotion of industrial exports and the production base for them was the centerpiece of policy under the military regime. In 1985, 55 percent of Brazil's exports were manufactured products as compared with three percent in 1960. Brazil's exports subsidies and incentives together with its protectionist policies have caused increasing frictions with the United States and West Germany, and probably with other industrial countries as well. Its state capitalism is also vulnerable to charges of distorting relative prices, misallocating and wasting resources, bureaucratic inefficiency and being almost suicidally autarchic with respect to high technology.[61]

Not the least of the criticisms of the Brazilian system has been the dominant role of the state in economic life. What tends to be overlooked is that the industrial transformation of Brazil over the last two decades has also created a large entrepreneurial class in the thriving private sector. State enterprises are concentrated in certain basic industries—chemicals and petrochemicals, mining, steel and transport service. But private firms, both domestic and foreign, dominate all other industrial sectors and agriculture, too. While many of these firms undoubtedly benefit from government programs, many others are probably competitive on world markets or could be, even without government help. The existence of this large, dynamic and internationally-oriented sector makes plausible President Sarney's assertions that his government intends to restrict the role of the public sector. In a recent article, he wrote:

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[59] Lowenthal, Abraham F. "The Peruvian Experiment Reconsidered" in McClintock and Lowenthal, op. cit., 1983.

[60] Schydlowsky, op. cit., p. 229. This belated enthusiasm for industrialization and industrial exports was apparently not shared by the Belaunde administration. Orthodox stabilization-cum liberalization became the policy of the Belaunde administration that was elected for the 1980–85 term, and the Peruvian economy, according to Schydlowsky, remained depressed because of what he calls a "deindustrialization and anti-export" policy. Exporters tried to force a change in that policy in 1983, but export promotion did not become the chief object of policy during the rest of Belaunde's term.

[61] A current, succinct critique of Brazilian economic policies appears in the August 1986 issue of World Financial Markets, Morgan Guaranty Trust Company of New York.

> We have an unshakeable belief in the role of private initiative in the economic recovery of the nation. Thus we are setting a broad program designed to create conditions favorable to a thriving entrepreneurial freedom in our country.
>
> But, in addition to the old concepts of eschewing state control and of selling public sector assets, putting the Brazilian economy in private hands calls for a broad curtailment of the interventionist and regulating presence of the state in the economy. This is a new posture; economic development is now to be led by a well-structured private sector, free of the paternalism of the state. Thus is buried, together with its authoritarianism, the government's role as arbiter in the economy.[62]

The Sarney government has taken some steps to reduce the government's role in the economy. It has divested itself of some small parastatal firms; designated a number of others to be sold; sold shares of the state oil company's stocks valued at $400 million to the private sector; and announced that shares of other state enterprises will also be sold, although the government will still maintain majority control as required by law, and, in fact, is not expected to go much further in reducing government ownership of industrial firms in the near term.[63]

If Sarney really means to carry out his promise of sharply reducing the state's economic role, he will have a difficult time of it. As Schneider implies in his article, there seems to be no great public demand to have the goverment divest itself of its enterprises, or even relinquish majority control to the private sector. Some of the state firms even enjoy good reputations, and the shares made available to the public are considered top blue chip stocks. Schneider also implies that some of the giant enterprises may have large deficits because they have large interest payments to make abroad that originated in loans they obtained not for themselves but at the behest of the Brazilian treasury which were used for balance of payments purposes.

In any case, Sarney's main ally in reducing the government's large intervention in economic life is the private sector and the influence that it can bring to bear on public opinion. But liberalization both in the sense of giving private enterprise much greater scope and in the sense of reducing import protection will not be perceived by the private sector as ends in themselves unless it becomes apparent to Brazil's elites that further growth is impossible without these correctives. That perception now seems to be growing as a result of the recent decline in private investment, and other danger signs such as the narrowing of the trade surplus and the decline in the country's exchange reserves in the last few months of 1986.

## PART V. CONCLUSION

### IS A LASTING DEMOCRATIC CONSENSUS POSSIBLE?

There may now be underway in South America a process establishing the unique legitimacy of the democratic system. In Latin America, Anderson points out, elections, revolution and military dictatorship have long been accepted as alternative ways of ratifying power relationships. He suggests that the "legitimacy" of any of these political orders is weak. Anderson defines political legitimacy as follows:

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[62] Sarney, Jose, "Brazil: A President's Story," Foreign Affairs, Sumner, 1986, p. 111.

[63] Schneider, Ronald M., "Implications of Brazil's Foreign Debt," Working Draft for Congressional Research Service's Workshop on Debt and the Future of Democracy in Latin America, June 1986, p. 6.

> Political legitimacy is that characteristic of a society which enables men to disagree vigorously over the policies that government should pursue or the personnel that should occupy decision-making posts, yet to support common notions of the locus of decision-making authority, the techniques by which decisions are to be made, and the means by which rulers are to be empowered.[64]

Whether the South American public ever considered revolution as a legitimate technique for social change is debatable. For a society which has long been marked by great social and economic disparities, South America has been remarkably unrevolutionary. Military dictatorship as an accepted way of confirming power relationships is another matter. The strength of the military alternative derived from the propensity of civilian political leaders to turn to the military to settle crises they brought on themselves by their unwillingness to compromise their differences.[65]

The same tendency to turn to the military for help occurred in Brazil and Peau. In Chile and Uruguay, social conflict from the 1930's until the 1970's did not reach a stage critical enough in the view of conservative groups to warrant overtures to the military to intervene.

## THE PROPENSITY TO MILITARY INTERVENTION

The propensity to rely on the armed forces to solve political crises rested on several key myths that the most recent experience with the military regimes should have invalidated. In Argentina, Brazil and Peru, these myths were grounded on military behavior in the interventions that took place prior to those of the 1960's and 1970's. In Chile and Uruguay, until the 1970's, most citizens probably thought it highly unlikely that their armed forces would ever overthrow a constitutional government. In the 1970's, as the economic and political situation in the two countries became increasingly unstable, the idea of military intervention seems to have become more and more acceptable. A key factor in this change of attitude was undoubtedly the assumption that if the military did assume power, their conduct would be relatively benign because of their history of respect for constitutional norms.

In the other three countries, and perhaps even in Chile and Uruguay in the early 1970's, the first myth was that the military intervention would be temporary, lasting only as long as necessary to overcome the political or economic crisis that had prompted the intervention in the first place. Supposedly, the military did not have the technical competence to govern for very long and, moreover, they themselves seemed to fear that a prolonged period of direct rule would create internal strains threatening their own unity. Accordingly, the myth held, once the armed forces had dealt with those responsible for the crisis, they would schedule new elections and let the winners take over.

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[64] Anderson, Charles W., "Towards a Theory of Latin American Politics," in Wiarda, Howard J., editor, "Politics and Social Change in Latin America: The Distinct Tradition," Second Edition, University of Massachusetts Press, 1982, pp. 310–311.

[65] For example, the tendency of Argentine politicians to rely on military intervention when things are not going their way has been described by de Imaz who writes: "Although they all deny it publicly, Argentine politicians can not ignore the fact that at one time or another during the past quarter-century, they have gone to knock at the door of the barracks." De Imaz, Jose Luis, "Los que manden": "las fuerzas armadas en Argentina," "America Latina," 7, N.4, October-December, 1964), P. 68, quoted in Snow, Peter G., "Political Forces in Argentina," Revised. edition, Praeger Publishers, New York, 1973, p. 66. A similar view was expressed by General Alejandro Lanusse, one of the leaders of the 1966 coup against the Illia government, commander-in-chief of the army in 1968–73 and president of the military regime from 1971 until the restoration of civilian rule in 1973: "The Argentine who sees that the government is not developing policies in accord with his own political ideas does not consider a solution based upon democratic procedures; instead, he at once falls into the temptation of thinking about the necessaity of intervention by the armed forces." The quotation from which the above statement is extracted appears on page 66 of Snow's book.

While most political leaders and the general public still clung to this myth in the 1960's and 1970's, a growing number of military officers and influential civilians had come to the conclusion that the traditional mediating and moderating pattern of military intervention had proved useless. In their view, increasing political polarization and mounting economic troubles were conclusive evidence of the failure of the traditional care-taking type of intervention. What was needed, more and more military officers were convinced, was a fundamental change in institutions and practices, and this would require a prolonged period of military rule. Many Chilean and Uruguayan military officers and members of the political elite had probably been of this mind even earlier than the 1970's.

A second myth that underlay the tendency of politicians to turn to the military was held primarily by centrist and populist politicians in Argentina, Brazil and Peru who were in opposition to the governments that were in office during most of the post-World War II era. The myth held that military officers, lacked the political and technical skills to run a government. Accordingly, they would soon tire of the chore and call new elections. In these elections, rival politicians stood to gain either by getting more electoral support than the former government party because the latter had been discredited by the military intervention or because the military had barred the ousted group from participating in new elections.

A third myth, parallel to the second myth, was subscribed to by conservative groups in all five countries. They, too, believed that the military considered themselves unequal to the task of governing civil societies for any extended period. But since the military were traditionally conservative, they would depend on the landowning and business elites for advice and for personnel to run the government for them. In any case, the conservative view was that the military could be counted on to defend the interests of the established order.

A fourth myth was that the military would respect lawful procedures in trying and punishing those implicated in or suspected of acts of violence against the regime and would respect the civil and human rights of other citizens as guaranteed by the national constitutions and by the military's own traditions of comparative civility in dealing with peaceful protest and opposition.

The fifth myth was that only an authoritarian government could end chronic inflation and make possible sustained economic growth. The economic troubles which the military regimes had inherited from the governments they had ousted were perceived to be the result of the lack of coherent, long-term economic policies. This incoherence was seen as the product of the inherent inability of democratic politicians to rise above short-term electoral considerations. To many conservatives who saw themselves doomed to remain permanently outvoted and out of power under a democratic electoral system, only a long-term military regime could ensure the continuity of appropriate policy that would produce sound economic growth.

## THE UNDERMINING OF THE MYTHS

The military regimes that came to power in the 1960's and 1970's undermined all these myths. The armed forces in all these countries—except Argentina in 1966–73—undertook the immense task of restructuring the political systems of their countries and, except in Brazil, the economic systems also. The armed forces not only felt confident of their ability to run their countries, but in the case of Peru filled virtually all their posts with military officers in the 1968–75 period. Far from protecting the interests of conservative groups such as large-landowners and the traditional business and industrial sectors, the Peruvian regime destroyed their political power. In carrying out policies promoted by advisors from the internationally-oriented business community, the Chilean, Argentine and Uruguayan regimes isolated themselves from much of their other traditional support: domestic industrialists, commercial farmers, plantation owners and ranchers, and professional association such as the independent truckers of Chile.[66] The intent may have been laudable: complaints and protests would supposedly be kept from watering down policies that were meant to bring about a modern, free market economy. After all, if the policies succeeded, then the very interest groups that had suffered losses in the interim would in the long run make these up many times over. What happened, in fact, was that too many people who were hurt by these policies and by the rigid way they were executed did not see things the same way. They joined with labor and the salaried middle class, the first groups to be alienated by the regimes, to form an opposition that left the regimes with so little popular support as to convince the military to turn government back to the civilians.

In Argentina, dissatisfaction with the military regime and its economic policies had been growing even before the Falklands war of 1982; in fact, the Argentine invasion of the Falklands seems to have been motivated by the military's desire to regain public support.[67] In Brazil, growing opposition to the regime during the regime's tenure was expressed in local and state elections whenever these were permitted and in the supposedly "rubber stamp" Congress.[68]

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[66] For Brazil: Bear, Werner, "Brazil: Political Determinants of Development," in Wesson, op. ct., p. 69; Chile: Valenzeula, Arturo, "Eight Years of Military Rule in Chile," Current History, February, 1982, p. 66 and "Prospects for the Pinochet Regime in Chile," Current History, February, 1985, p. 78; Argentina: Pion-Berlin, David, "The Fall of Military Rule in Argentina: 1976–83," Journal of InterAmerican Studies and World Affairs, Vol. 27, No. 2, Summer, 1985, p. 59; Uruguay: McDonald, Ronald H., "The Struggle for Normalcy in Uruguay," Current History, February, 1982, p. 73.

[67] Skidmore, Thomas E. and Smith, Peter H., "Modern Latin America," Oxford University Press, New York, 1984 p. 110.

[68] Roett, op. cit., Chapter 6.

In Uruguay, lack of public support for the regime was manifested in November, 1980 by a 58 to 42 percent rejection of a constitution that would have institutionalized the military's veto power over civilian governments of the future.[69] In Chile, a 1980 plebiscite gave the Pinochet regime a favorable vote on a new constitution, one of the provisions of which was the extension of General Pinochet's term as president. This was proclaimed by the government as an indication of the wide public approval of General Pinochet and his regime's policies. If this was really the public's attitude in 1980, instead of a rigged affair, that attitude had sharply changed by 1984.[70]

The assumption that the military regimes would observe basic human rights was proved invalid by all the regimes, although the severity and scale of the repression varied amont the different countries. In Argentina, perhaps some 12,000 people were tortured and killed.[71] In Chile, the number known to have died is unknown, but Skidmore and Smith describe the 1973 coup as the most violent in twentieth century South American history. They believe that between 5,000 and 15,000 people were killed.[72] In Uruguay, the number of people tortured and killed is unknown, but was apparently high, judging from the annual reports of Amnesty International which states that in the mid-1970's, Uruguay had the highest ratio of political prisoners in Latin America.[73]

In Brazil, the severity and scale of repression fluctuated. The total number of political prisoners tortured and killed during the 21 years of the regime probably did not exceed a thousand, but these abuses of human rights, together with the large numbers of people deprived of their civil rights or forced into exile, stamped the regime as the most repressive in Brazil's twentieth century history. Abuses of human rights also occurred in Peru, but the Peruvian regime was benign relative to previous Peruvian authoritarian governments and to the contemporary military regimes of Argentina, Brazil, Chile and Uruguay.

The actual performance of the military regimes disproved the myth that authoritarian rule was more effective than democratic governments in bringing about economic growth and monetary stability. Brazil, it is true, averaged a high annual rate of growth, 5.8 percent as compared with 3.5 percent for the civilian governments that were in power from 1950 to 1964. But, in effect, what the military regime did was to achieve higher growth rates in the present at the expense of some lowering of future growth rates. As a result of the extraordinary liquidity created by the OPEC oil prices boosts of the 1970's, the military regime was able to borrow abroad amounts far in excess of anything its predecessor civilian governments could borrow. It was thus able to keep a boom going far longer than the civilian governments of the precoup era could since they were periodically forced to cool off their economies because of foreign exchange shortages. The huge debt service payments that will now have to be be made as a result of the large increase in debt has lowered the amount of foreign exchange available for investment. Moreover, increased social expenditures will have to be made by civilian governments to make up for the neglect of the military regime. This, too, will cut into future growth rates. By rights, then, the reduction in future growth rates should be charged against the military regime, thereby lowering its average annual rate of growth, perhaps by as much as one to two percentage points.

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[69] McDonald., op. cit.

[70] Constable Pamela and Valenzuela, Arturo, "Is Chile Next?", Foreign Policy, Summer, 1986, p. 63.

[71] Simpson, John and Bennett, Jane, "The Disappeared and the Mothers of the Plaza" St. Martin's Press, New York, 1985, pp. 399-404.

[72] Skidmore and Smith, op. cit., p. 141.

[73] "Amnesty International Report 1977," London, 1977, p.162.

The Chilean regime was the only one of the regimes to perform well with respect to inflation after 1980. It has not been able, however, to end chronic inflation which remains at about the 20–25 percent level as compared to the 30 percent level of the pre-coup era. Moreover, only per capita GDP has grown about 0.8 percent annually under the regime as compared with 1.9 percent in the pre-coup era. Also, what has been said above with respect to Brazil concerning excessive external borrowing and social needs applies also to Chile, and in fact, to all the military regimes: future growth rates will be lower for some time to come because of the military regimes' policies.

## CONCLUSION

The "new-style" military regimes of South America proved to be cruel, costly, and, except for Brazil, ineffective in bringing about economic growth. Whether they were an historical necessity to prevent the threat of civil war or a Communist takeover is a question that the people of the area and their historians will have to decide for themselves. In any event, the responsibility for the advent of the military regimes rests primarily on the civilian political elites of the pre-coup era who preferred military intervention to political bargaining and compromise to overcome the differences among them. Without the perception that these leaders represented a majority of politically concerned citizens or at least a very substantial number of them, it is doubtful that the armed forces would have acted on their own.

A prominent Brazilian general, Golbery do Couto e Silva, whom Stepan has called the theoretician of the Brazilian National War College, put it this way:

> Military activists for or against the government are alway a minority. If a military group wants to overthrow a government, they need to convince the great majority of officers who are either strict legalists or simply nonactivists. Activists do not wish to risk bloodshed or military splits, so they wait until a consensus has developed. Thus movements to overthrow a president need public opinion to help convince the military itself. This was so in 1945, 1954, and 1964. In 1961, the military chiefs acted against public opinion and had to back down.[74]

Stepan's own study of the media and their relation to military coups in Brazil strongly supports General Golbery's view.[75] Golbery and Stepan refer to the Brazilian experience, but their contention that the military must feel they have public support if they are to move against an elected government is also applicable to the other South American countries. This view also explains why the military gave up trying to govern in these countries, beginning with Peru in 1980, and ending with Brazil and Uruguay in 1985. In these countries and in Argentina where the military restored civilian rule in December, 1983, the military were under no threat of armed insurrection or even of much street violence, which they could in any case have made short shrift of. What was apparent to them was that they had lost any semblance of legitimacy, and they did not wish to continue without it.

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[74] Stepan, Alfred, "The Military in Politics: Changing Patterns in Brazil," Princeton University Press, Princeton, N.J., 1971, p. 97.

[75] Stepan, Ibid., pp. 99–115.

In Chile, the case is more complicated. Public opinion there appears to be ambivalent. As unpopular as the regime seems to be among the lower and middle income groups and as much as apparently even the latter would like to see democratic government restored, they also seem fearful of a return to the political and economic instability of the past. Since so much ambiguity surrounds what public opinion really wants, the Chilean military have good reason to believe what they want to believe, namely that the Chilean people do not really want them to retire from power.

In the other countries the lessons learned and the myths unraveled by the bitter experience with the military regimes have restored legitimacy to democracy in Uruguay, and given to democracy in Argentina, Brazil and Peru a legitimacy that it never had before. At the same time, even a strong commitment to democracy can not endure if democratic leaders cannot get their economies to grow. And these economies are unlikely to grow unless some solution to the debt problem is found. This is the single greatest obstacle to growth because current interest payments on the external debt absorb far too high a percentage of the area's foreign exchange earning to permit the volume of imports needed for investment and growth. Lower oil prices and lower interest rates in 1985 and 1986 have offered some relief. Most South Amercian countries have been able to increase their non-oil imports, but not enough to support the investment needed for faster growth. Table 14 shows the magnitude of interest payments in 1985.

TABLE 14.—SELECTED LATIN AMERICAN COUNTRIES: INTEREST PAYMENTS ON EXTERNAL DEBT AS PERCENT OF EXPORTS AND OF GNP, 1985

| Countries | Interest payments [1] (billions) | Exports [2] (billions) | Ratio: payments to— | |
|---|---|---|---|---|
| | | | Exports [3] (percent) | GNP [1] (percent) |
| Argentina | $5.1 | $8.4 | 60.7 | 7.9 |
| Brazil | 11.8 | 25.6 | 46.1 | 5.8 |
| Chile | 2.1 | 3.8 | 55.3 | 12.9 |
| Peru | 1.3 | 3.0 | 43.3 | 10.8 |
| Uruguay | .5 | .9 | 55.6 | 10.2 |
| Colombia | [4] 1.3 | 3.3 | 39.4 | 3.7 |
| Costa Rica | [4] .6 | 1.0 | 60.0 | 16.2 |
| Dominican Republic | .7 | 1.2 | 58.3 | 6.5 |
| Mexico | 10.8 | 22.3 | 48.4 | 5.5 |
| Venezuela | 4.1 | 14.9 | 27.5 | 7.9 |
| Total (or average) | 38.3 | 84.4 | 45.4 | 10.8 |

[1] Loomis, Carol J. "Why Baker's Plan Won't Work," Fortune, December 23, 1985.

[2] Department of State, Bureau of Inter-American Affairs, Economic Data Charts.

[3] Calculated by author.

[4] Ibid.

Economic growth can occur under almost any form of government provided that government can assure political stability. For that reason, probably more countries have developed their economies under authoritarian governments than under democratic systems. In traditional societies, where authoritarianism has long been accepted as though it were ordained by nature, political stability is more or less assured, and the changes required for development or brought about by it can be managed for long periods with a minimum of repression. Real problems for the central authority begin when economic development creates new social groups with conflicting interests. In most of South America, this stage was reached some time ago. The attempt by the military regimes to reinstate the authoritarian road to development failed in all the countries except Brazil. But Brazil was and is an exceptional case where vast land area and enormous natural resources have made for a frontier mentality and a national consensus for growth at all costs which antedates the military regime of 1964–85.

In the other South American countries, economic growth did occur for a sustained period of time under the military regimes, except in Argentina. But even during this period of growth, the people who at first seemed to support military intervention grew hostile to it when the military broke with precedent and decided to govern on a long-term basis. Their objections to prolonged military rule undoubtedly rested in part on the unprecedented repressiveness of the regimes, and in part on the fact that large sectors of the public did not share in the general prosperity of the growth period. But probably a more important factor in the loss of support for the military was that the major social sectors including the traditional civilian ruling groups found themselves powerless to influence public policy.

Peru, perhaps, brings this point home more clearly than in the other countries. Here the military regime carried out social reforms that benefited sectors that had been traditionally excluded from national decision-making—urban workers, poor farmers, landless agricultural workers, low and middle income salaried employees, artisans and owners of small businesses and industries. At the same time, in order to keep their social revolution under control, the military bypassed the traditional associations and parties that represented these groups. With no sense of participation in the formation and execution of the regime's policies, these groups made no move to defend General Velasco, the leader of the reform movement, when he was ousted in 1975 by more conservative officers.

Brazil was the only one of the countries under the "new style" military regimes considered in this paper to achieve a high rate of sustained economic growth in the 1965–85 period. There is no agreement among the experts on why Brazil proved to be an exception in this regard but a number of factors appear to account for it. For one thing, Brazil's vast land area and enormous material resources together with an energetic business community made for a developmentist consensus. Secondly, the Brazilian military regime was more pragmatic than its sister regimes. It did not undertake to change overnight the statist institutions and protective practices that were deeply rooted in its culture. Moreover, it did not isolate itself from its indigenous business community but relied on it for policy formation and execution. Finally, it went further than the other military regimes by maintaining a better feedback system. For most of its period in office, the Brazilian regime permitted local and state elections, permitted a "loyal opposition" party in the national congress and tolerated a substantial measure of freedom for the media. The feedback was limited in that the opposition and the media operated under restrictions that were arbitarily tightened from time to time, and the congress itself had little real power. All things considered, however, the Brazilian regime's relative openness to criticism helped keep it more pragmatic and quicker than the other military regimes to correct deficiencies in policies.

There is much to criticize about the Brazilian regime's overall performance. The regime was relatively benign compared to the other regimes, but it was still probably the most repressive in Brazil's twentieth century history. It proved unable to prevent a soaring inflation in the last years of its tenure, and it saddled the country with an enormous foreign debt. It neglected urgent social problems, and some of its public works projects may be of dubious worth. Its huge public sector made it deficit-prone, and some of its trade practices were of questionable legality under GATT rules. The fact remains, however, that Brazil's growth performance under the military regime was the highest in Latin America in the 1960's–80's and was surpassed by only six or seven other oil-importing countries of the free world. In two decades, a primarily agricultural nation was transformed into an industrial power as a result of an import substitution policy that was centered on increasing exports of manufactures and diversifying agricultural exports.

In the late 1940's, the East Asian countries understood and acted upon the need to increase industrial exports as the best means of achieving self-sustaining economic growth. To come up with a similar strategy, it took the Brazilians almost two decades more, marked by political instability, inflationary booms, several failed stabilization programs, and five coups and coup attempts. And it took 20 years of military dictatorship to carry it out.

If a political consensus on such a growth strategy could have been reached in the 1950s, Brazil and perhaps the rest of South America could have been spared the military dictatorships. Such a consensus was not impossible. The strategy was one from which all social sectors stood to gain. In the early 1960s, a few South Americans understood this and tried to convince those in power that such a strategy was possible. They were not listened to by the civilian political leaders of the day, but their ideas were in the air, and the Brazilian armed forces, alone among the South American military, were receptive to them.

The civilian government that in March, 1985 succeeded the military regime carried on essentially the same economic policies, although it initiated a land reform program and devoted more resources to welfare purposes. The Brazilian economy continued to prosper in 1985 and 1986, but in the last months of 1986, danger signs appeared. The trade surplus which had been running at an annual rate of about $12 billion declined to $9.5 billion for the whole year. Foreign exchange reserves, while still high at $5 to $6 billion, fell about $1.5 billion in the last few months of 1986. Gross Domestic Product which rose in real terms by 8.2 percent in 1985 increased at about the same rate in 1986 but was expected by only four or five percent, "conceivably six percent," in 1987.[76]

Even more ominous, inflation rose sharply in early 1987 as a result of wage increases and decontrol of prices.[77]

In June 1987 with inflation at an annual rate of about 1000 percent, the Sarney government reinstituted a freeze on prices and wages. The question arises, as to whether the Brazilian development model is inherently inflation-prone. A tentative answer is that despite its faults, it was not the model but the failure of leadership that has permitted the resurgence of inflation. Determined to win the national elections of November, 1986, the Sarney government delayed austerity measures too long. The syndrome is not unknown among democratic governments. But it is also not uncommon among military governments, either, as the case of Brazil itself and of the other South American military regimes, except the Chilean, attest.

In the last analysis, perhaps the main thrust of the recent South American experience is that while authoritarian economic management proved to be no better than civilian management, Brazil under both civilian and military leadership demonstrated the effectiveness of a development strategy that is geared to exporting manufactures. As the prolonged slump in primary commodity prices shows—Argentina's export prices, for example, have declined every year since 1980, and in 1986 were 40 percent below the 1980 level—no country can hope to avoid the boom-and-bust cycle if it continues to rely chiefly on exports of primary and lightly processed allied products. Nothing is more economically and politically destabilizing than these periods of over-heated expansion and harsh contraction.

An industrial export strategy is not enough in itself to ensure sustained economic growth and political stability, but growth and political stability do not seem possible without it. An alternative growth strategy that would be just as effective in the Latin American context as the Brazilian approach but less subject to retaliatory measures by its trading partners and less inflation-prone would be better for all concerned. Unfortunately, no other South American country has as yet come up with a better answer.

The failure is not for lack of trying. The Chilean, Argentine and Uruguayan military regimes were so sure they had the magic key to prosperity and internal peace that they put their people through immense hardships to prove they were right. What they proved, instead, is that growth and prosperity can not be brought about by a dispirited and harrassed entrepreneurial class and resentful workers. The Brazilian way of developing entrepreneurial capacity and productive workers may not be as effective as the North American market approach but in the Latin American environment—which historically has not been distinguished by aggressive business leadership—it worked. The question remains, however, whether it can continue to work under a democratic government that will have to modify the growth-at-any cost strategy in order to control inflation and attend to social problems which the military dictatorship ignored.

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[76] Department of Commerce, International Trade Administration, "Latin American Trade Review 1986: a U.S. Perspective," Washington, DC, March 1987, p. 33.

[77] The Wall Street Jounral, February 13, 1987.

# POLITICAL CHANGE IN LATIN AMERICA: A FOREIGN POLICY DILEMMA FOR THE UNITED STATES*

By Viron P. Vaky

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## SUMMARY

A good many of the major foreign policy problems the United States has faced in recent years—Latin America, Africa and Southeast Asia—have been essentially questions of how to deal with indigenous political dynamics and change in the light of global balance of power concerns. Because nuclear realities have placed a cap on the way in which the two superpowers confront and struggle directly with each other, conflict between them tends to get pushed out to the peripheries and to take place in indirect ways. At the same time, security interests conflict with our traditional humanitarian concern for the liberties and well-being of peoples in the Third World.

This essay is concerned essentially with Latin America, and it seeks to deal with the question of how U.S. policy and policymaking can better relate to domestic structures and internal political dynamics in the countries of this hemisphere if undertaken in a network of multilateral cooperation and governance patterns. A number of regional mechanisms and procedures are recommended to coordinate and systematize cooperation in the areas of development capital and balance of payments aid, domestic economic policy, human rights, migration, and collective security and conflict settlement. To be effective, multilateral governance ought to embrace non-hemisphere metropolitan powers such as Great Britain, France, Holland and Spain. Honest multilateralism will require

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the U.S. to extend a great deal of trust and confidence to our friends.

## THE AMERICAN STYLE

In thinking about long-term policy and policy choices, we need to be aware of the American predilection for what Stanley Hoffman has called "formulism", i.e., the tendency to shorthand or to sum up complexities in slogans and "solutions".[1]

Thinking of issues in terms of set formulae risks misperception and oversimplification, confuses assumptions with aspirations, and may lead to unrealistic expectations. It also impedes necessary policy tasks including the need: (a) to blend aims that are often diverse; (b) to assign priorities to conflicting interests; (c) to carry out rigorous cost/benefit analyses of various options and to allocate appropriate means to various ends; and (d) to appreciate accurately the consequences of what one *is* doing.

We need to remind ourselves that we cannot assume that a given policy will always yield a particular result, and that, on the contrary, the same policy instrument can have different results depending upon the particular circumstances and context. Moreover, the generic nature of an issue does not by itself automatically dictate the policy measure to be used. There are instances, for example, in which economic growth has fostered political stability and instances in which it led to instability. Helping to professionalize a military to make it apolitical and a supporter of pluralism can, instead, induce it to seize power. Not every insurgency or development situation can be met by the same policies.

There is also deep in the American style and ethos basic ambivalences, and, as Hoffman has pointed out, a 'dualism" in the "image" the United States wants to present to the world. We like to think of ourselves as the product of a revolution, of colonial emancipation. Yet we also stress that we are for order, stability, legality, and peaceful not violent change.[2] And so we are surprised if, at times, others perceive us as defenders of the status quo and as "counter-revolutionary". Dualism is also reflected in our tendency to speak two different languages—the language of power and the language of community. There is in us, in short, a tension "between the instinct for the use of force and the drive for harmony." [3] Such qualities result in deep ambivalences in our foreign policy which we frequently fail to resolve and sometimes even fail to recognize.

## DICHOTOMIES IN U.S. NATIONAL INTERESTS

An awareness of these dualisms is important because they interact with the fact that in foreign policy the United States faces substantive and real dichotomies in its national interests—between the imperatives of geopolitics and of our humanitarian values, between the global superpower conflict and the requirements of good regionalism, between the requirements of security and the need to express the kind of nation we are.

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[1] Stanley Hoffman, "Gulliver's Troubles or the Setting of American Foreign Policy," New York: McGraw-Hill, published for the Council on Foreign Relations, 1968, pp 140–142.

[2] Ibid., p. 177.

[3] Ibid., p. 181.

The liberties and well-being of other peoples have been persistent and traditional concerns of Americans for much of our modern history. Difficulty arises, however, when these humanitarian purposes appear to diverge from what self-interest and security would seem to require. There are those who argue that humanitarian concerns—democracy, human rights, justice—are "soft" interests, nice things to do if one has the luxury to afford them, but not to be confused with the demands of our "hard" interests—those involved with our security.

This complexity and intractability, interacting with our own dualities and interests, makes it especially hard for U.S. policy to deal with the problem of political change. While we recognize the need for change and sympathize with the urge for freer societies, we are uneasy with instability, and feaful of opening the way to disorder and extremism. We tend almost reflexively to believe that a "quiet" socio-political situation is a healthy one, and that progress can always be moved through legal channels. The tendency is to favor "orderly" or incremental change—from the top. However, there is an obvious inherent contradiction in urging the beneficiaries of a given status quo to reform. An elite's long-term interest in reform that might avoid "revolution" runs smack up against the short-term likelihood that such reforms would dislodge it or reduce its power. Elites benefited by a given status quo usually oppose reform and label it an opening wedge to Marxism. In the end, while we have expressed our support for political democracy, we have more often than not opted for political order—not, it should be added, always successfully in terms of long term peace and stability.

A major question that arises, then, is what are the boundaries of what we believe we can tolerate in the way of internal instability? What is it we feel we cannot risk? We support diversity in principle, but our definition of acceptable diversity tends to be narrow. What is the range of the political spectrum we feel would not pose risks? Can we tolerate leftists, socialists, Marxists if they are not linked to the Soviets—or are they automatically linked to the Soviets? Does the presence or support of any Marxist element taint any group, however diverse, or any cause, however intrinsically legitimate? A subset of questions is the degree to which we feel we need also to shape the paths or instruments of development. Are some economic models acceptable and others to be opposed? Should we use training benefits, scholarships, and aid only for "safe" elements? While these are questions that have to be decided in terms of specific cases, the conceptual issues are reflected in them.

## DEALING WITH LATIN AMERICA: FOUR APPROACHES

In the fact of such puzzles a range of policy concepts emerge. There are those who argue that the United States ought to stay out of other peoples' internal affairs; that we do not understand them and cannot shape them; that we should just get out of the way and let these societies find their own level. The result may be a variety of systems and ideas, some of which will not please us, but none of which is by its intrinsic nature likely to threaten us.

Still others argue—variously—that these nations lack the educational and institutional bases, the historic experience and political tradition to approach "democracy" as we think of it; or that they possess a political tradition that is based on pre-Lockean, traditional Catholic conceptions of the "collective good" which differs from our own Lockean liberal conceptions of pluralism and popular sovereignty; or that a kind of Hobbesian dynamic operates in these nations, particularly in the smaller, less advantaged countries, in which regime instability and violence are endemic, integral and predictable parts of their political systems. Hence—in all of these views—authority and order are the primary values for such societies. We should, therefore, be realistic about it—the argument goes—and understand that reforms cannot make much of a contribution to stability because political cultures change slowly; and that efforts to press reform will only disrupt order and unravel the polity. Our primary objective, hence, should be to support friendly regimes that can maintain order and authority, and that will support our foreign policy goals (usually meaning anti-Communism).

Still another view argues that, as difficult as developing political institutions might be, there is in these countries a basic commitment and desire for open political systems and for a more equitable distribution of both economic product and political power; and that the urge for redress and for equity is a constant and compelling element that will lead to trouble if frustrated. The degree to which even authoritarian regimes feel the need to give lip service to plans for "return" to elected government, and the persistence with which the cycle keeps returning to constitutional rule, are cited as some evidence of this. This view argues that the pace of change can be increased, and the trauma decreased—or conversely that fragile democratic regimes can be protected—by helping provide some otherwise missing ingredients, such as development capital, educational opportunities, technical assistance, and by international encouragement and pressure, including the linking of such benefits to socio-political progress and economic reform. Since external sources cannot shape the final outcome, these inputs are designed, in this conception, to improve the ability and capacity of the various elements of society to structure their own pluralistic processes.

And still others argue that if the inputs are massive enough we can in fact manage and promote a change in a fairly short run, as for example the massive aid programs aimed at the Dominican Republic after 1965 and our programs for Grenada and Central America. This view argues that we should consciously use our leverage and power selectively to the degree necessary to shape the kinds of change we would find compatible with our interests.

## POLITICAL CHANGE AND SUPERPOWER CONFLICT

An entirely different set of dilemmas arises if we approach the matter of domestic political change in these countries from the top, i.e., in terms of the superpower conflict. If we react to internal turmoil and domestic ideological strife in these societies essentially in terms of what that may say for our global image—"credibility," managing "our backyard," etc.—or in terms of "raising the cost" of Soviet adventurism and containing Soviet expansionism, then our policies and actions will effectively be designed with an eye on Moscow and Havana and primarily for extraregional ends. The problem with this is that it tends to divorce policies from any real connection with local complexities and legitimate issues, and yet such policies will have local impact and local costs in resources and lives. If the use of our power and influence is driven fundamentally by extraregional purposes, the message sent to the indigenous populations is that they do not in the last analysis count for much; they are just unlucky to be caught in a big power game. The obverse of this is that local actors will seek to cast their local struggles in terms of international ideological and global balance of power arguments. Local solutions designed for external reasons are seldom likely to be self-sustaining or long-lasting, even in terms of the global picture. On the other hand, if there *are* hostile exogenous elements fishing in troubled waters how does one deal with that and protect legitimate security interests?

And so at every point we are pushed back to the basic dichotomies—between regionalism and global geopolitics, between our humanitarian aims and our security needs—and to the divergencies of our national interests and our own dualism. If we look at the connections among (a) problems of political change in these countries; (b) the radicalizing of unrelieved dissent and frustration: (c) our regional and global interests; (d) our security requirements, and (e) conclusions about the kind of nation we want to be, there are two alternative poles of concepts.

## Alternative Foreign Policy Concepts

One would be that the United States should generally disassociate itself from questions of a nation's internal structure, and attend to those situations only in cases of clear Soviet/Cuban intrusions. Otherwise we would let what happens happen. The problems with this approach are, first, that it does not take into account issues which can provoke serious insecurity in the absence of Soviet-Cuban interventions, e.g., debt repudiation or human rights atrocities. Secondly, it would engage our policy only at the most deteriorated and dangerous point—when a Soviet/Cuban threat was unambiguously clear—and when the only option left might be confrontation. It foregoes the opportunity of earlier, less risky measures, such as timely reforms, which might diminish Soviet-Cuban opportunities.

The alternative conceptual pole is to assume that we can take no risks, and that the United States must therefore consider the region a U.S. preserve, exercising in effect a hegemony which would seek to make us the arbiter of what is acceptable or unacceptable in internal political conflicts. The premise would be that Soviet/Cuban incursions or power projections are not the only threats to us, others being the rise of indigenous "leftist" or "radical" elements because of their potential convergence with Soviet power. Where the first approach would have us ignore the domestic make-up and watch only for the Soviets and their allies, the second would have us look closely at the nature and methods of domestic forces, determine who are the "good guys" and who are the "bad guys", and oppose the latter.

This second view recognizes, as the first does not, that our interests can also be damaged or threatened by hostile or unfriendly forces which are *not* Soviet/Cuban supported or inspired. But it is flawed in that this kind of hegemony is a recipe for extraordinary overextension. It would commit our power not only to defense of borders against exported subversion, but the preservation of governments from internal change. It places such a high priority on order that it may neglect the fact that many "friendly" regimes refuse to reform in time or to deal adequately with dissent. And if we are not to "undermine" them by pressuring them, we become the victims of our clients, risking acquiescence in repression or mismanagement which breeds radicalization.

Obviously, these are opposite poles at the extremes, and one cannot answer broad policy questions in terms of conceptual abstractions. One has to deal with each case on its merits, and we need various mixes of instruments, policies and risk assessments. We will need to go somewhere in between withdrawing from the field and reentering only when the Russians and their allies approach, on the one hand, and on the other hand, turning the whole region into a division between good and bad. We need to find our way between the sentimental illusion that nations can pursue ideals and moral crusades without reference to interests, and the cynicism that holds that the nation in practice has no obligation beyond self-interest.

## Guidelines for Foreign Policy

What, then, might be appropriate guidelines for determining the mix, the in-between points?

—First, no policy is likely to achieve domestic consensus and bipartisan support that does not support socio-economic and political reform as a major goal, and this support can not be just rhetorical lip service to quiet critics and cover hidden agendas.

—Secondly, concern for economic growth and social justice and demonstration of a clear preference for open political systems over authoritarianism constitute the basis for an effective strategy to protect security interests. Over the long-term, self-sustaining stability and peace are not likely to happen without these broader goals of justice and equity. To base our security interests on the idea of only supporting order and authority and keeping things quiet is to build on sand.

—Thirdly, a proper approach to the question of political change in Latin America should not *begin* from the *top,* i,e. the superpower conflict, but from the bottom, i.e., from a clear understanding of the aspirations, ambitions and problems of the internal forces in the particular society we are concerned with. We need to understand that their main concerns tend not to be the superpower contest per se, but their own struggles and objectives, and their own desire to be treated as independent forces, not as tools. We have interests that transcend any given country or region, of course, and so we do have to combine respect for the "will-to-autonomy" and for the forces of nationalism with the need to avoid unbearable outcomes. But we need urgently to find effective ways to increase the chances that ongoing developments in the region will be more rather than less favorable to us.

—Fourth, having said all of that, we need to understand that our capacity to bring about democracy, growth and justice is limited, and that we must to be realistic in our expectations. We can provide many of the ingredients that these objectives require, which can help unleash the ingenuities and energies of these societies. We cannot, however, shape or even always predict the outcome; least of all can we prescribe the structures.

—Fifth, to say that we need a basic policy framework for fostering change, justice and development does not mean that we can be unconcerned about security matters. Security will not automatically take care of itself. Security assistance to enable these countries to cope with legitimate public-order and subversion problems, for example, is a perfectly appropriate policy tool. It *does* mean, however, that such assistance needs to be conceived of and carried out *within* the setting of an overall policy aimed at more just, open systems; and it needs to be designed specifically to bolster *those* goals, with the limitations clearly in mind. We can view the military establishments in these countries as a necessary part of security problems, but not necessarily as a solution to *political* problems. And we need also—given the present day constraints and limitations on our power—to be much more precise than we have been about how much we can risk and not risk, and about the costs and consequences of options open to us.

## THE RISKS OF "PLAYING IT SAFE"

The kind of quasi-imperial hegemony we have historically tried to exert, and the basic impulse we still feel almost reflexively in time of crisis that we can only trust ourselves—our presence, control and power—to keep things "safe" will now be counterproductive for five reasons:

—It is overextension. It will be extremely difficult if not impossible in our political system and culture to maintain over time the continuity in resource flow, vigilance and power application that effective hegemony would require; moreover, the more we hold the lid on developments the less we can ever let go.

—It would create nationalistic back-lashes. It risks converting nationalism into anti-Americanism because the overwhelming presence of the United States and the psychological dependence created by power asymmetry means that any legitimate nationalism, and any will to autonomy, any desire for change in the status quo would necessarily have to find their identity by defining themselves in opposition to us.

—It is even conceivable that the mere weight of our predominent power and leverage—"being in bed with an elephant"—could force elements seeking change to extremes (Marxism), not out of philosophical conviction, but as tactically the most effective way to offset us. We would risk converting our contiguous neighbors into the mirror image of the Eastern Europe-Soviet relationship.

—It maximizes the opportunity for ethnocentricity to distort our perceptions and comprehension.

## TOWARD A MULTILATERAL APPROACH

It would seem more prudent for the United States to help form and energize a network of multilateral cooperation and governance patterns—a kind of "regional hegemony" as it were—to help cope with common problems and common security and welfare concerns. These arrangements need not be overly formalized. They might well use existing institutions or create ad hoc patterns in the traditional intermediation which has historically marked the inter-American system. The point would be to involve the nations of the region in defining and meeting mutual interests.

I am not talking about cosmetics, about clothing bilateral hegemony in multilateral clothes, or structuring a facade of cooperation which we intend to control and guide behind the scenes. I mean honest multilateralism, give-and-take cooperation, which will require us to extend a great deal of trust and confidence to the structures. This will not be easy. We Americans have as difficult a time dealing with friends as with enemies. While we persistently stress harmony and consultation, and frequently invite other nations to join us in carrying out our schemes, we refuse, in Stanley Hoffman's words, "either to endorse proposals that might entangle us in policies we would be unable to determine, or to allow them to share in the determination of our policies." [4]

Second, I have in mind not just United States and Latin American nations; multilateral governance to be effective ought to embrace non-hemisphere metropolitan powers—Great Britain, France and Holland—and perhaps Spain which as the mother country enjoys extraordinary credibility.

What might such multilateral patterns look like?

—In development, it might systematize cooperation among the international financial institutions, perhaps through the existing World Bank Development Committee, as the main channel for transmitting major development capital and balance of payments aid. It might foster agreements on specialization of labor—with AID let us say, focusing on technical assistance, the World Bank on major infrastructure projects, the Inter-American Development Bank concentrating on export industries promotion, etc.

—In economic policy terms, one might systematize periodic consultations among economic ministers to exchange views and undertake commitments and programs as is currently done in the OECD. This would be in the tradition of the InterAmerican Committee for the Alliance for Progress (CIAP).

—In human rights terms, nations could strengthen the Inter-American Human Rights Commission as the principal instrument for dealing with human rights problems. Multilateral instruments are likely to be more effective—and more accepted—than unilateral foreign pressures.

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[4] Ibid., p. 199.

—In migration matters, one might establish an office or expert staff, under the OAS charter provisions for establishing specialized agencies, to assist nations—in an ombudsman, non-prescriptive manner—to deal with these problems. This might be especially useful in facilitating consultations and problem solving where tensions, pride and nationalism may impede or disrupt normal diplomatic channels or consultations.

—In the crucial areas of collective security and conflict settlement, any number of regional mechanisms and procedures can be considered. One could envisage, for example, the establishment of mechanisms or procedures to provide standing verification and monitoring services for agreed settlements; or standing services for observing and providing technical aid on elections. Fact-finding and investigation services could be institutionalized to assist peaceful settlement functions. A procedure could be established by which OAS member states would report to the Secretary General annual data on military expenditures and weapons sales and purchases, as well as advance information on the size and disposition of forces and on anticipated maneuvers—such as is now done in NATO and between NATO and the Warsaw Pact. The Secretary General could publish such data periodically with the purpose of reducing fears and suspicions and shedding public light on these matters.

Whatever the instruments and tactics, the important thing is to develop a realistic conceptual framework for our relations with Latin America and the Caribbean area and firmly to undertake a commitment to this controlling vision. If such a conceptual view can be worked out and accepted on a bipartisan basis, then our specific actions should flow naturally and consistently with our enduring values and purposes.

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